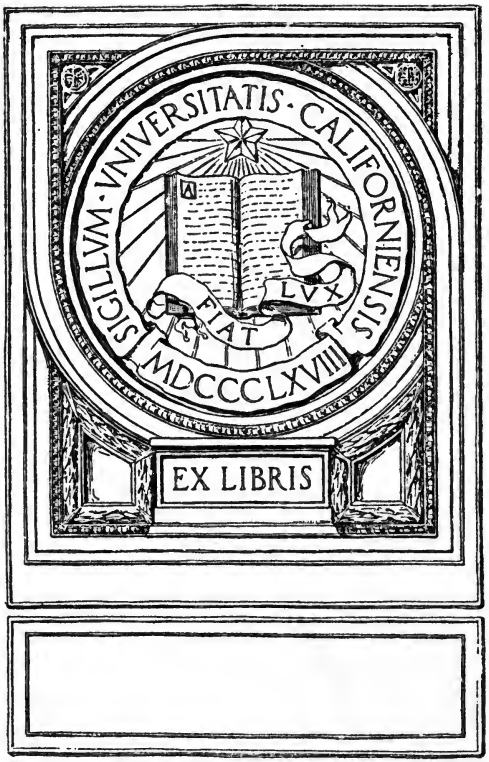
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Mercantile Credits

A Series of Practical Lectures Delivered Before the Young Men's Christian Association of Los Angeles, California

BY

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PREFACE

The mental equipment of the successful business man of today can hardly be too complete. The amount of information requisite for the proper conduct of his business exceeds that required by the business man of any other age. His information must be accurate and must cover a wide scope. What he knows he must know well. He is constantly called upon to pass upon questions of great importance, and he must decide without delay. His decisions must be based:

First, upon the business wisdom of accepting or refusing the opportunities offered.

Second, upon a hurried review of the legal problems involved. It is impossible to keep an attorney constantly at his elbow to pass upon every transaction, and therefore he must have a working knowledge of business law.

Third, upon keen judgment of human nature and human character. The aphorism of Alexander Pope, "The proper study of mankind is man," applies with greater force to the business man than to others.

The National Association of Credit Men labors unceasingly to educate its members in all those subjects which are so vital to their success. By bulletins, letters, lectures, and debates, the propaganda has gone forward. But the older members of the Association have found it

extremely difficult to secure junior clerks who have even an elementary knowledge of the basic principles of business and credits.

In an endeavor to inform and assist the members of the Los Angeles Association, and to place in training young men who might thereafter be available for positions of trust in credit departments, the Los Angeles Credit Men's Association requested the Young Men's Christian Association of Los Angeles to establish a lecture course on these subjects, and agreed to extend all possible co-operation. The very excellent organization of the Young Men's Christian Association took hold of the work with great enthusiasm, and the result was a series of lectures which, it is believed, will be helpful to all young men engaged in active business, as well as to those contemplating such a career.

The subjects were chosen to cover as nearly as possible the fundamentals of business practice and business methods; and it is hoped that those who faithfully followed this course of lectures, and those who now study it in its present form, will derive a fund of practical information from it that will not only be of direct value, but will give them a better understanding and appreciation of the basic principles of three essentials of business success—good judgment, legal knowledge, and an understanding of human nature.

NEWMAN ESSICK

May 1, 1914

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Mercantile Credits

CHAPTER I

SYSTEM AND EFFICIENCY IN THE CREDIT DEPARTMENT*

By M. Martin Kallman

Importance of the Credit Man's Position

Credit is the basis upon which commerce and nations subsist; or, to put it another way, credit is the foundation upon which business is built—upon which its very existence is dependent. This being so, it is interesting to inquire what sort of men bear the responsibility of granting or refusing credits. We shall find them in widely varying positions. Sometimes the credit man is a partner in the firm, sometimes a salesman, oftentimes merely a bookkeeper. But whatever his rank, the results of his work are equally important.

No one is in a better position than the professional business systematizer to know how much is demanded of the credit man; for the credit desk is the first place to which he is conducted when he begins an engagement. He is first taken there because the credit man is supposed to

* By permission of Mr. Kallman.

know something about everything upon which the other officials of the establishment are not compelled to be informed.

The Credit Man's Routine

Whatever the house has in the way of an accounting system is generally the work of the credit man, and though the result is not always deserving of unqualified praise, the fact still remains that upon his shoulders has fallen the burden of meeting the requirements of accounting progress. Again, if a blank or a special form is needed in any department, the task of drawing it up usually falls to the man at the credit desk. Then, too, the larger problems of house finance are almost invariably submitted to him. Quite frequently, indeed, the credit man is the active financial head of the house. Again, particularly in small houses, he is often charged with the buying of the house stationery and numerous petty details of a similar nature, which, in addition to his main routine duties, make him the most overworked member of the house staff.

Yet the credit man needs, more perhaps than any other official, to have the advantage of that liberation from the slavery of petty details which it is the mission of modern business system to bring. If any man in the organization of the modern business house should have time in which to think, and to think without interruption or annoyance, it is the credit man. The poorest possible economy in which an establishment can indulge is that of so crowding the man at the credit desk that he has to work his pencil more than his brains.

The Duty of the Credit Man

The credit man really earns his money by the skill with which he handles a comparatively small percentage

of the total number of accounts under his care. In making this statement I have little fear of contradiction. Let us say, for example, that at least 90 per cent of the accounts passed upon by the credit man of average experience and ability are sound and, broadly speaking, above suspicion. Then the real value of his services to the house rests upon the judgment and diplomacy with which he passes upon the remaining 10 per cent of accounts which cannot quite meet the standard set up for Cæsar's wife.

System as an Aid to Efficiency

It will require no unusual acumen to see that, if the task of scrutinizing the 90 per cent of sound accounts can be reduced to so small a minimum as to demand comparatively little of the credit man's attention, both he and his house will be immensely the gainer, as he will have far more time and energy to devote to those accounts which really call for the exercise of his best energy, judgment, and protective powers. This is only another way of saying that the traditional routine duty of passing upon the 90 per cent of solid accounts has often compelled the credit man to treat the dubious 10 per cent in a hasty and perfunctory fashion, and occasionally to commit errors which have had serious consequences.

How shall the conditions be so readjusted as to permit the credit man to concentrate practically all of his attention upon the doubtful 10 per cent of accounts, knowing that the substantial 90 per cent is being adequately cared for and protected without his constant and specific attention? System alone can solve this problem—system which "flags" orders on any account in the least degree doubtful, and at the same time allows the right of way to all orders on accounts in a proper condition.

In other words, a right method makes it possible for any member of the credit department having the intelligence of an ordinary clerk to pass upon the credit of customers obviously in condition to take care of their orders. At the same time, it makes it impossible for a single extension of credit to be made on any account not deserving it.

Operation of a Credit System

By way of illustration, let us suppose that the credit man of Merchant & Company goes out to luncheon and meets his friend from down the street, whose house sells goods to many of the customers of Merchant & Company. This friend inquires: "Do you sell Jones, of San Diego?"

"Yes," answers our credit man, "he has a very good line with us."

"Well," responds the friend, "that may be all right, but I have just heard from a reliable neighbor of his that he has been speculating rather freely of late, and is believed to have suffered severe losses; in fact, my informant declares that he is pretty deep in the hole, and that he is likely to have a rather hard time of it for several months to come. Very likely, though, he will be able to pull through all right, unless some of his creditors or backers get scared and begin to shut down heavy on him."

Now, if the credit man of Merchant & Company has his office organized under a right system, the first thing he does after he has returned to the office and hung up his coat and hat, is to take from the card record of house customers the particular card bearing the name of Jones, of San Diego. On this he pencils his own initials. This initialling is a signal which automatically stops all orders and transactions, and immediately refers them to his personal attention. Every employee of the office knows that to allow an order to pass this signal without being specifi-

cally referred to the credit man, is to violate a cardinal rule of the house, and to incur a severe penalty.

But this is not all. In an appropriate space on the card which bears the record of all the transactions of Jones with the house, he notes the reason for such summary action in altering the line of credit which the customer has previously enjoyed. The card then shows a complete statement of the conditions.

On the other hand, let us suppose that this credit man is a representative of the old school. He prides himself upon his ability to carry "under his hat" the key to the credit of his customers; and, so far as his written records are concerned, there is no change in the standing which Jones, of San Diego, enjoys with the house.

The credit man of the old school knows that he is going to tighten the line so far as Jones is concerned, and he feels that it is enough that *he* knows it. But it happens that our credit man suffers from an attack of indigestion a day or two later and is compelled to stay at home to recuperate. If he has an assistant, he has forgotten to tell him the story of what happened to Jones in the ups and downs of the market—for credit men sometimes do forget. While our old-style credit man is dieting at home, Jones sends in an uncommonly heavy order. There is not a scratch of a pencil, or a black mark of any kind, against his name; and consequently the order goes through, the goods are shipped, and by the time the chief of the credit department is convalescent and back at his desk, Jones, of San Diego, is a successful bankrupt and the house is the loser.

Instances of this kind, as every credit man knows, are happening every day; but they cannot occur in any establishment where a credit department is operated under an adequate and thoroughly modern system.

Result of Lack of System

One of the most marvelous things in the history of merchandising is the amount of dearly bought experience required to teach the average business man that his "Customers Ledger" is not an inspired volume invested with miraculous infallibility, and that the credit man who carries his knowledge of his customers "under his hat" is, sooner or later, bound to have his hat and all that is under it in the wrong place at the critical moment—a fact which makes him a mighty poor and inadequate supplement to the customers ledger.

Some years ago, when the bicycle habit was at its height, the half-owner and credit man of a big Eastern jobbing house was called from his desk to attend the funeral of a friend. While returning from this sad mission he chanced to be in the same conveyance with an acquaintance from a smaller city in a neighboring state. This friend asked: "Does Mr. Blank, of my town, still deal with you?" "Yes," was the answer, "we sell him a big line of goods; in fact, his business is increasing right along, and he is among our best customers."

"Well, I like him all right," replied the friend, "but I happened to learn something yesterday which I feel in duty bound to tell you. As yet it is little known, but I can vouch for the fact that he is transferring his real estate holdings to his wife. This, to my notion, means that he is fixing for a first-class failure and that you will do well to get from under."

When this credit man returned to the office he punctiliously consulted the ledger and looked at the account of this particular customer; but the ledger showed that Mr. Blank had recently remitted a sum which balanced the account.

The other partner of the house had exclusive control

of the merchandising and selling end of the concern, but never ventured to interfere with the affairs of the credit department, nor did he permit his associate to interfere with his own branch of the business.

Now, while the credit man was absent attending the funeral, Mr. Blank had called at the establishment and personally placed an order for several hundred bicycles. Of course, the partner at the head of the selling department consulted the ledger and found his customer's account in excellent condition. The order was put through and the goods shipped in haste, in accordance with the special instructions left by the visiting customer.

The day following the funeral which the credit man had attended, the merchandising partner was called out of the city and did not return for several days. As a result, before the big order for wheels was posted on the ledger and came under the eye of the credit department chief, the shipment had been received by Mr. Blank, disbursed, and that enterprising retailer had gone into bankruptcy.

Scores of other incidents along this line might be cited, all emphasizing as pointedly as this the moral: "Customers ledgers are not sacredly infallible guides"—and the further fact that the credit man who carries his information under his hat is as useless to his house at times as he will be eventually when there is crepe on its door and the partners and heads of department are attending his funeral. This kind of a credit man leaves his money behind him, but his information dies with him, and all the ledgers in the world will not save it—particularly if there is a few days' delay in the matter of posting, as is likely to be the case in a house where so little of modern system obtains.

Perhaps you are inclined to ask how this disaster could have been prevented under the operation of an up-to-date

system. Just as soon as the customer came into the house and made application for so large a draft upon his credit, someone from the selling department should have quietly visited the credit desk. Finding the credit partner absent, and failing to find any specific data, aside from a clear balance on the ledger, he would have drawn the card of Mr. Blank from the record and placed it upon the credit man's desk, together with a memorandum of the order. Immediately upon the return of the credit man this information would have been forced upon his attention and, as a result, the shipment of the goods would have been stopped.

System as an Aid to the Salesman

Another practice common in poorly organized business houses is that of encouraging customers to buy their goods before the house definitely determines whether, under existing circumstances, the invoice involves a larger line of credit than it desires to extend. For example, a customer comes into the wholesale house and spends half a day in buying a large bill of goods. This also involves half a day's time on the part of the salesman. After he is all through selecting his goods, the order gets up to the credit desk, and it is discovered that the customer's account is not in condition to warrant the new bill. Then, after the customer and the salesman have both wasted their time, the buyer is told that his line of credit will not stand the additional strain of the amount involved in his purchase. Naturally, this causes disappointment and makes bad blood. Very often, too, it results in the permanent alienation of a good patron of the house.

If a proper system is enforced, the first thing in order when a customer enters the house and signifies his intention of buying, is to send to the credit department records

and get his number. This at once tells the employee or salesman precisely the line of credit to which he is entitled. Thus forewarned, the salesman is in a position of advantage, and by the exercise of a little diplomacy—the giving of a little sound advice regarding the extent of the customer's purchases—he is able to keep the order within the proper credit limit, thus avoiding disappointment, waste of time, and perhaps the permanent loss of a customer. It is a safe rule that the house salesman should learn the exact amount of credit to which the customer is entitled before he begins the actual process of taking that patron's order. And this can always be done without the customer's knowing that the salesman has this information.

Advantages of Personal Contact

As the present chapter is intended to offer practical and helpful credit suggestions, I shall not hesitate to indulge in a word of criticism. One of the most serious weaknesses of the average credit department is found in the comparatively slight personal intercourse between the credit man and his customers. To a very large extent their communications are not only written, but of a formal, cut-and-dried nature. While it is true that the credit man does see certain of his customers quite frequently, it is equally true that he has no personal acquaintance at all with a very large portion of them. The cause of this condition has already been indicated. The head of the credit department is tied down to his desk by an elaborate network of details which, under an adequate system, are safely and expeditiously taken care of by inexpensive help.

It is my conviction that every credit man should come into personal contact with each one of his customers at

least once a year, and oftener if possible. And the right sort of a system will make it possible for each customer of a house to be personally seen once a year by some person in a position of authority in the credit department. If Mahomet will not visit the mountain, let the mountain visit Mahomet. When the customer cannot be induced to call upon the credit man, let the credit man call upon the customer. In no department of business does the personal equation have greater weight than in the credit department; and it is absolutely impossible for the personal equation to be accurately determined except by personal contact.

The Credit Man as a Selling Factor

Another conclusion which has been forced upon me is that, generally speaking, the credit man does not realize his power as an active selling factor. He is in the habit of thinking of the credit department as purely protective instead of as a possible productive factor. His relation to the effort of the house to make more sales should be as constantly in his mind as the effort to see that the sales actually made are safe. Very few letters should go out of the credit department without containing some reference to more orders or further orders from the customers. The credit man should know at once when the purchases of any good customer are falling off, and should take steps to learn the reason for this change. Of course, this must be done with tact—but tact and judgment are two necessary qualifications of the credit man.

The Credit System as a Character Record

A good credit system is so sensitive that it indicates, with automatic precision, the character of the customer. You do not need to be told that kicks and complaints are

the favorite weapons of customers who believe that they have some advantage to gain by sharp practice with the house from which they get their goods. It does not generally occur to such a customer that the house will remember that he has registered a kick a month ago; but the little card bearing his record indicates at a glance every time a complaint was entered.

Let us suppose that a new customer sends in his first complaint. Under the right kind of a system this is immediately indicated on his card record. At once instructions are sent out through the house to double-check his next shipment, and to exercise especial care in every detail relating to it, even to seeing that the packing of the goods is done in a manner beyond criticism. If this customer enters another complaint next month, he is then considered a subject of suspicion, is placed under surveillance, and a special effort is made to arrive at his motive for the complaint. In the same manner the good system takes care of the matter of slow pay and of all other elements entering into the customer's relationship with the house.

Proper Use of the Mercantile Agency

A frequent element of weakness in credit departments is the too implicit reliance upon mercantile agency ratings and reports. Do not understand me as attempting to minimize the great value and usefulness of the agencies. They are an absolute necessity for the safe conduct of business under the complex conditions of our modern commercial life. On the other hand, you will hardly question the statement that they are the crutch upon which both the weak customer and the weak credit man are inclined to lean too heavily.

The country merchant who is not financially as strong or as sound as he would like to be, takes especial pains

and goes to any length to build up his ratings in the commercial agencies, while the credit man who is either timid or inexperienced, and who has not the advantage of a system which stores accurate and available information regarding all his customers, is disposed to base too many of his decisions upon the reports of the agency. In doing this he is sometimes in danger of giving too short a line of credit. Many a house organized on a small capitalization does not show all of its strength in its statements to the commercial agency, for the very good reason that assessors and tax-raising bodies, as well as merchants, have access to agency information and know how to use this information to the increase of the tax returns. For example, a certain Eastern house, capitalized and rated at $100,000, actually does a business of more than a million dollars a year. It is scarcely reasonable to suppose that so large a business as this is done upon so small a capital as that represented by the rating of the house in the mercantile agency report. There are many other reasons why the credit man should be in a position to render his judgments practically independent of the agency reports, or at least to use them by way of verification. And this he cannot do unless he has a system which provides the right information and crystallizes it into permanent office records in such a manner that it is instantly—almost automatically—ready for application to every case and every customer.

Results of System

These hints will be sufficient to show how a thoroughly modern system in the merchandising house, and especially in its credit department, makes it possible for the credit man to concentrate practically his whole attention upon the matters which need his attention, instead of

squandering his time and energies upon a mass of details which daily pass over his desk simply because long usage and tradition so decree. By taking advantage of the economy wrought by well-devised modern office methods, any credit man can enormously increase the power and influence which he exerts in the house organization, giving his best efforts only to those matters which are really worthy of them.

That the proper systematization of the operations of the credit department will effect a much-desired economy of the time, labor, and energy of the credit man is a truism; but to what extent system will be made an accomplished fact in connection with credit work is very largely dependent upon the interest the credit man exhibits in this subject. If he advocates such a policy, and adopts and promulgates the forms and methods required to carry it into effect, half the battle is won. Of course, individual systems will differ according to individual needs, but it is greatly to be desired that certain forms should be prepared for general use, and certain uniform lines of action adopted, with a view to liberating the credit man from slavery to details, and leaving him free to make his individuality the power that it should be in the house organization.

CHAPTER II

CREDIT DEPARTMENT METHODS

By Alfred K. Care

Importance of Credit Methods

Factory methods, sales methods, and accounting methods are now made the subject of careful study by the up-to-date manufacturer and merchant. Credit department methods are surely of equal importance. In fact, the success of a business house depends largely on the wisdom, judgment, and courage of its credit man, and the methods adopted by the credit man are what he depends upon to bring results.

Confidence is the basis upon which the whole business structure rests, for in order to carry on business at all, men must trust one another. Bank notes and greenbacks, popularly called money, are merely promises to pay; and their acceptance is an expression of confidence in the ability and willingness of the government to pay their face value on demand.

Unfortunately, however, confidence is sometimes misplaced; and in the past we have often been too liberal in the extension of credit. Sufficiently close investigation of the applicant for credit has frequently been neglected, and this neglect has led to many business failures. The improved methods, now being adopted by credit men, are greatly reducing the losses of their respective houses, which are thus enabled to meet competition with more

success and to do better by their customers. It is obvious that these methods are worthy of careful study.

Cooperation with the Sales Department

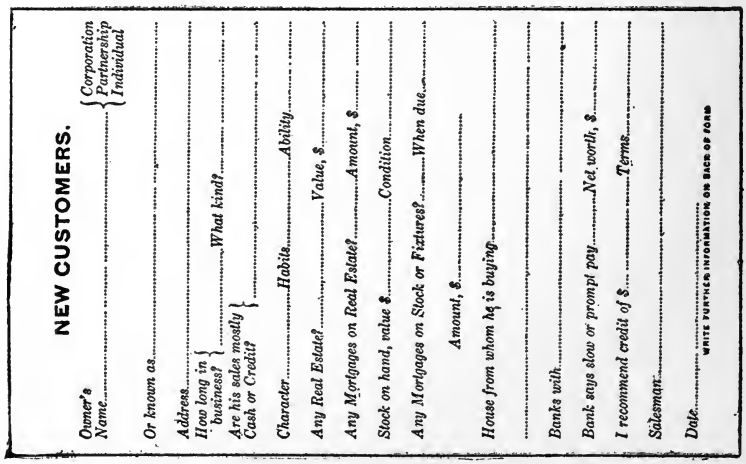
One of the first points in the consideration of credit department methods is the relation between the credit department and the sales department, which in the past have not always worked together harmoniously. The desire to sell goods is uppermost in the mind of the sales department, and too frequently the conservatism of the credit man is overruled by the head of the house in his desire not to lose business which a competitor may take over. In more recent years, however, the credit man has been given greater authority; and in most business houses of today, his decision is final. He has achieved this recognition by careful study of his subject, and by adopting various methods to get all the information possible, not only as to prospective customers but as to those who may have been on the books of the firm for many years, thereby placing himself in close touch with the financial condition of all the clients of his house. It is this positive knowledge which gives weight to his opinions.

Work of the Credit Man

The first duty of the credit man is to obtain all the information possible regarding the applicant for credit; the second, to analyze the information obtained—and here is where his experience, ability, and judgment are brought into full play. He should be an accountant, or at least should have sufficient knowledge of accountancy to be able to analyze intelligently a customer's financial statement. At times he may even be required to inspect a customer's books and draw off a statement; and without a knowledge of accounting this would be impossible.

Gathering Credit Information

The credit man cannot obtain too much information regarding his customer, and he should instil into the minds of his salesmen the desirability of informing him of every circumstance affecting the customer, whether it be favorable or unfavorable. Every salesman should be required to carry a block of forms similar to those shown below, one of which is filled out for each new customer. The salesman is not expected to ask the customer any of the questions on the form, but to obtain the information in the course of conversation with him or others. All this information is properly noted and filed with the records.



NEW CUSTOMERS.

Owner's Name..... { Corporation / Partnership / Individual }

Or known as.....

Address.....

How long in business? { ..... What kind? .....

Are his sales mostly Cash or Credit? { .....

Character..... Habits..... Ability.....

Any Real Estate?..... Value, $.....

Any Mortgages on Real Estate?..... Amount, $.....

Stock on hand, value $..... Condition.....

Any Mortgages on Stock or Fixtures?..... When due.....

Amount, $.....

House from whom he is buying.....

.....

Banks with.....

Bank says slow or prompt pay..... Net worth, $.....

I recommend credit of $..... Terms.....

Salesman.....

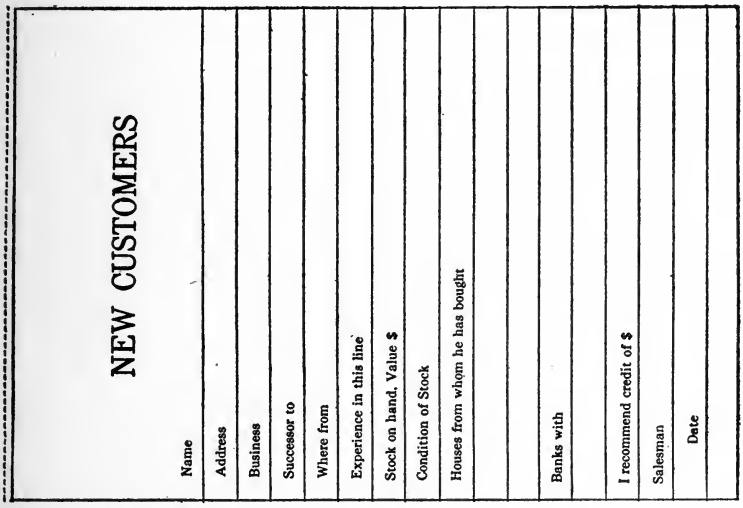
Date.....

WRITE FURTHER INFORMATION ON BACK OF FORM

Salesman's Report on New Customer (First Form)

The first question after name and address, is "How long in business?" Now, the question of experience is an important one, as the length of time a man has been in business or has worked for others, enables one to gauge his ability to some extent.

Another very important question—as to the value of stock—is easily answered according to information obtained from the man himself, confirmed or corrected by the estimate of the salesman, who ordinarily is a good judge. The condition of the stock is open to observation. The name of the customer's banker and names of firms buying from him are also readily obtained. When we come to the question, "What amount of credit do you recommend?" the salesman should be in a position to answer with assurance; and my experience has been that as a rule he is fairly conservative in his views.


NEW CUSTOMERS

Name
Address
Business
Successor to
Where from
Experience in this line
Stock on hand. Value $
Condition of Stock
Houses from whom he has bought
Banks with
I recommend credit of $
Salesman
Date

Salesman's Report on New Customer (Second Form)

Commercial Agency Reports

The salesman's report is sent in with an order, we will say from John Smith, Lansing, California, and duly reaches the credit department, which at once proceeds to gather all the information it can with reference to John Smith. Here we discover the usefulness of commercial

agencies such as Bradstreet's and R. G. Dun & Co. An inquiry is made of one of these agencies—possibly both—for a report on John Smith, Lansing, California. When it is received, you find that according to Smith's own statement he is married, and therefore can exempt real estate to the extent of $5,000 in that state; that he has a stock of $10,000; outstanding accounts, $3,000; fixtures, horses, wagons, etc., $2,500; cash, $500; real estate, $2,000 clear of encumbrance; homestead, $3,000; and insurance for $8,000. His liabilities consist of trade indebtedness, $4,500; indebtedness to bank, $1,500; other borrowed money, $2,000; and he considers himself worth $10,000 over and above all debts and exemptions. The report then proceeds to give the result of the agency's investigation of his statement, which is practically confirmed; it also states that the various houses interviewed report him prompt in his payments, and that he is reckoned, from the standpoint of credit, at an estimated net worth of $5,000 to $8,000. All of this being favorable to Mr. Smith, his order is OK'd for credit.

Other Sources of Information

Those unfamiliar with credit work will say, "Why, how easy!" and it certainly would be easy if Mr. Smith's case were a fair sample. But, unfortunately for the credit man, when he most desires quick information on his customer, the agency is without any, or what it has is of little value. On the other hand, he may receive the information that Mr. Smith's statement is not confirmed, that his indebtedness is much greater than he states, and that his payments are very unsatisfactory, which is certainly valuable information. However, we need not depend entirely upon the agency report. Our salesman has furnished us with the name of Mr. Smith's bank, and those of the prin-

cipal firms from which he is buying; and we have communicated with these parties either by telephone or letter, the result being favorable or otherwise, as the case may be. A commonly used form of credit information letter is as shown on page 26.

If the information is not entirely favorable, we immediately write Mr. Smith, thanking him for his order and asking him for a financial statement and for references, basing our request on the fact that he is a stranger to us. And if Mr. Smith furnishes us with a signed statement of his financial condition (even though the outside information may not be quite as favorable as we could desire), we are inclined to grant him a line of credit, for the reason that he would, under certain conditions, be criminally liable if he made a false statement.

In the first case we apparently took no risk in granting Mr. Smith credit; in the second case, there was an element of risk which we partially overcame by obtaining the financial statement. By keeping in close touch with Mr. Smith's condition at all times, we could possibly continue to grant a line of credit with safety.

It must be remembered, however, that credit is not always based solely on a man's assets. Often credit is extended largely on the known honesty and integrity of the customer, and on the knowledge or belief that he would not incur a debt he did not see his way clear to pay when due. This is the moral risk, and the credit man must depend on his own judgment to handle it successfully.

MICHAEL CUDAHY, President
CHICAGO, ILL.

EDWARD A. CUDAHY, Vice-Prest. & Genl. Manager
SOUTH OMAHA, NEB.

THE CUDAHY PACKING CO.

LOS ANGELES, CAL.

Credit Department

*Los Angeles, Cal.,*_____*1914*

_____

_____

*Dear Sir:*_____

Will you kindly give us your opinion of the financial standing and general reputation for promptness, responsibility and integrity of the undernamed? Your reply will be held confidential and we will gladly reciprocate at any time.

Yours truly,

The Cudahy Packing Co.

*M*_____

_____

_____

_____

_____

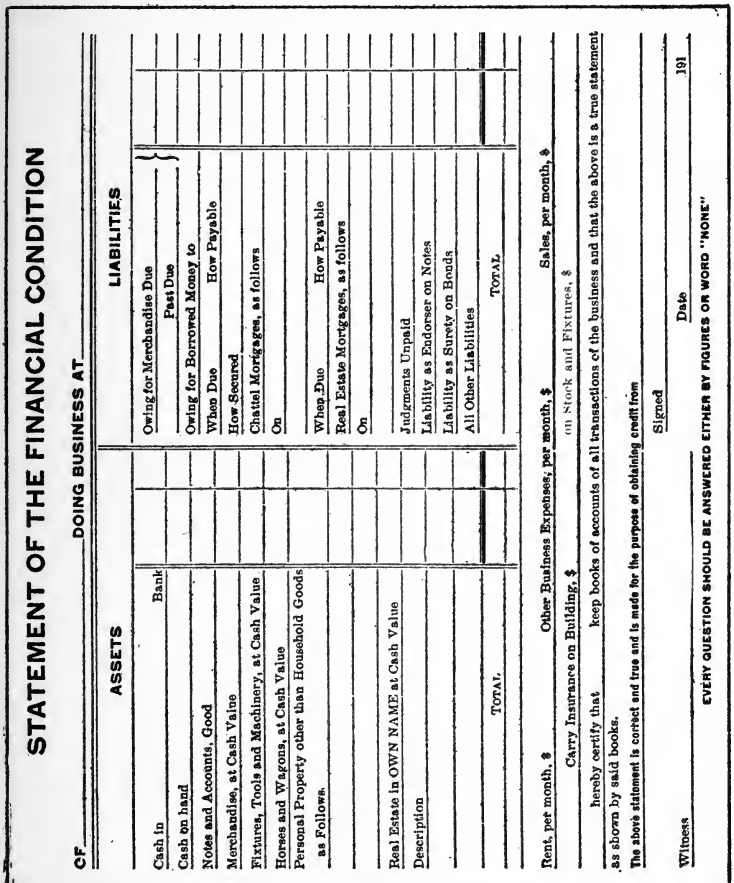
_____

*What do you consider his net worth? $*_____

Credit Information Letter

Financial Statements

There are various forms used for financial statements by different houses. Good statement forms used by prominent concerns are as follows:



STATEMENT OF THE FINANCIAL CONDITION

OF _____ DOING BUSINESS AT _____

ASSETS		LIABILITIES	
Cash in Bank		Owing for Merchandise Due	
Cash on hand		Past Due	
Notes and Accounts, Good		Owing for Borrowed Money to	
Merchandise, at Cash Value		When Due How Payable	
Fixtures, Tools and Machinery, at Cash Value		How Secured	
Horses and Wagons, at Cash Value		Chattel Mortgages, as follows	
Personal Property other than Household Goods as Follows.		On	
		When Due How Payable	
		Real Estate Mortgages, as follows	
		On	
Real Estate in OWN NAME at Cash Value		Judgments Unpaid	
Description		Liability as Endorser on Notes	
		Liability as Surety on Bonds	
		All Other Liabilities	
TOTAL		TOTAL	

Rent, per month, $ _____ Other Business Expenses, per month, $ _____ Sales, per month, $ _____

Carry Insurance on Building, $ _____ on Stock and Fixtures, $ _____

I hereby certify that keep books of accounts of all transactions of the business and that the above is a true statement as shown by said books.

The above statement is correct and true and is made for the purpose of obtaining credit from

Signed _____

Witness _____ Date _____ 191

EVERY QUESTION SHOULD BE ANSWERED EITHER BY FIGURES OR WORD "NONE"

Financial Statement

The National Association of Credit Men has a very simple and effective form of property statement (shown

PROPERTY STATEMENT

Made for the purpose of obtaining a line of credit from Cudahy.

Name of Applicant.....

Address.....

City..... State.....

Details of Ownership.

Individual .....

If Firm, give names of Members.....

.....

If Corporation, give State under which formed .....

Date .....

If more than one place of business give details.....

.....

.....

Property Statement (page 1)

in Chapter IV); and in it are these statements which are so true and so much to the point that they may well be quoted here: "Large assets are not always necessary to the creation of credit. A merchant's capital is the sum of his net available resources plus his credit. A merchant

FINANCIAL STATEMENT

As per Books of Account as of Date.....

RESOURCES

Merchandise on hand, at actual cost			
Shop fixtures, furniture, and tools, present value			
Notes and accounts, good			
Notes and accounts, doubtful			
Cash in Store			
Cash in what Bank.....and amount.....			
No. of Horses.....No. of Wagons..... Fair value ofBoth			
No. of Automobiles.....Fair value			
All other personal property other than household goods, and what it consists of			
..... and fair value			
Real Estate (give details in Schedule "A" (see page 4)			
*Is any part of same a homestead?.....If so, what is value			
*Amount of Life Insurance.....To whom payable			
*Do not include two above items in total.			
TOTAL			

Property Statement (page 2)

who desires to serve his own best interest should recognize that his most valuable possession, apart from his actual assets, is a sound, substantial, and unquestioned reputation as a credit risk, and that under the prevailing conditions and demands of business, the most effective and

LIABILITIES

Give names of parties to whom owing for merchandise, and amounts			
Are any of the above accounts past due? Name them			
Have you any suits pending against you? Amount?			
Do you owe any judgments? Amount?			
Do you owe for tools and fixtures? Amount?			
Do you owe anything for wages past due? Amount?			
Do you owe any rent on business premises? Amount?			
Do you owe anything to relatives, and to whom?			
When payable How secured			
Other borrowed money? From? Amount?			
When due? How payable How secured			
Any Bank overdrafts? Amount?			
Judgment notes? If so, state amounts and to whom given			
Amount liability as endorser on Notes or Surety on Bonds?			
All other liabilities			
TOTAL			

Net Resources (deduct total liabilities from total resources)

Property Statement (page 3)

eminently the best way to prove his basis for credit is to be willing to submit a statement of his financial condition."

Value of Bank References

Personally, I do not place much confidence in a bank reference, as human nature is the same everywhere. If

Real Estate Owned. **Schedule "A"**

Lot.....Title in.....Value.....Insured for.....
Lot.....Title in.....Value.....Insured for.....
Lot.....Title in.....Value.....Insured for.....
Lot.....Title in.....Value.....Insured for.....
Any Real Estate Mortgages?.....Amount?.....

ON WHAT PROPERTY	WHEN DUE	TO WHOM GIVEN	AMOUNT

Schedule "B"

Any chattel mortgages on your stock, fixtures, horses and wagons or other property?.....

ON WHAT PROPERTY	WHEN DUE	TO WHOM GIVEN	AMOUNT

Rent of store per month $.....Other business expense per month.....
Insurance on stock and fixtures $.....Insurance on building $.....
Name Fire Insurance Companies.....
.....
Does homestead include store building?.....When did you commence business?.....

Certificate.

.....191..

.....

.....

Gentlemen:—For the purpose of obtaining credit with your Company for Merchandise which applicant may now or hereafter obtain and purchase of you I hereby certify that applicant keeps books of account of all transactions of the business and that the foregoing statements are true and represent the financial condition of applicant as shown by said books, and that the other statements above contained are true and correct, and that I am duly authorized to make this statement on behalf of applicant.

Dated this.....day of.....191..,
at.....in the State of.....

Authorized signature firm or corporation.....

Signed by (member of firm or authorized officer).....

Witness:

.....

Property Statement (page 4)

the merchant happens to be a customer of the bank, the latter will naturally recommend him for credit; whereas some other bank in the same town might either give an unfavorable report, or so word its reply that you could

infer anything you wished. In the reference of the wholesaler or jobber, however, I place every confidence.

Personal Judgment as to Credit Standing

We will now take a case where James Brown calls at your place of business to place an order. He is introduced to the credit man, who, in the course of conversation, ascertains that the business is a small one and that the amount of credit desired is light. The formality of a written statement is therefore not required, but the figures given by Mr. Brown as to his assets and liabilities, and the names of the houses with which he does business, are all jotted down, and form part of the record which is kept of all customers, further details of which are given later. In case Mr. Brown is likely to desire considerable credit, a financial statement is required, which, when verified or corrected, can be filed with the other credit records.

Occasionally unfavorable information reaches you in reference to one of your established customers, and every effort must then be made to ascertain the facts. If the party is in the city, someone is sent to make a personal call and get at the truth; incidentally, of course, collecting all the money he can. In the meantime you have made a credit call through the local wholesalers board of trade, or some other similar association, the purpose of which is to secure information as to the total amount owing by the merchant to its members, the total of what is past due, and also the manner in which the party makes his payments. On receipt of this you may find that your customer's indebtedness is heavy, and the amount past due sufficiently large to embarrass him. Your next move is to collect what is owing to your firm, or, failing in this, to persuade him to call a meeting of his creditors, at which

his affairs can be discussed and an extension agreed upon by all the creditors, or an assignment made for their benefit.

The Personal Touch

Make it a point to see the man to whom you are extending credit, if possible, and preferably at his place of business. Get in close touch with your customers at least once a year. Many is the time that I have met an insolvent customer for the first time at a creditors' meeting, and often have I felt that had I only seen him before, I should not have been present at that meeting.

A good credit man should always be a good mixer, and should have a good understanding of human nature. I had an instructive experience only a short time ago. One of our country customers had been a little slow in his payments, and very touchy when written to on the subject of his delinquency. I had an opportunity to visit him at his place of business, and was in his store fully twenty minutes before I was given any attention. In the meantime I noted the condition of his stock, the appearance of his help and of the store in general, and decided that if I could collect our account, there would be no more credit for him. On introducing myself the first thing I heard was a tirade against the house, the goods, and finally myself. I took it all good-naturedly, and when he said, "I'll give you a check for my account and never buy from your house again," I accepted his check, told him he would probably think better of it, but registered a vow that he would never buy again on credit. Six weeks later there was a call from the local board of trade, and his affairs were put in their hands. Needless to say, I was not a creditor.

Trade Reports

When the credit man receives trade reports, he examines them carefully, and notes such as are of special interest to him. His assistant cuts out all items pertaining to the customers of his house, pasting them neatly in their respective folders.

Watching Details

One of the failings of the embryo credit man is in trusting too much to memory; another the failure to note details, such as the size of an order. I have a distinct recollection of one such error where a credit assistant mistook an order for a car of eggs for a case of eggs and OK'd it. In the shipping department no such error was made, the order being rightly understood as calling for a car of eggs. The car was shipped, and sold by the customer, who left the country within twenty-four hours after, and the house sustained a loss of several hundred dollars. We are all liable to such errors, and the only way to guard against them is to surround yourself with all the safeguards available.

Recording Information

Collecting data with regard to his customers, and keeping it in such a form as to be readily "get-at-able," are exceedingly important features of the credit man's work. The method adopted by myself is to have a numbered folder in which all information regarding the customer is kept, including the salesman's report, mercantile agency reports, reports of references, credit calls, information obtained from court records as to transfers of realty, mortgages, etc.; copies of all letters written requesting payments, with replies, if any, also memoranda of all

3526

THE CUDAHY PACKING CO.

NAME John Jones TOWN Los. Angeles

BUSINESS "The Star Grocery" STATE California

231 E. 1st St.

ACC'T. OPENED	1/13			DATE	2/13					
CREDIT LIMIT	$100.00			BRAD.	X-E					
TERMS	30 Da.			DUN.	K3½					

REMARKS: Banks: 1st National Bank

Credit Information Folder

postdated checks received or checks thrown out of the bank on account of insufficient funds; in fact, anything and everything pertaining to his credit. The number appearing on the folder also appears on a card—as shown below—which bears the customer's name and address, terms, limit of credit allotted him, together with mercantile agency ratings and dates of same, etc.

NO. 3526 NAME John Jones,
ADDRESS 231 E.1st St.,City.
LIMIT $100.00 TERMS 30 Da. ACCT. Provisions
L. A. FORM 69 2M 11-13

"The Star Grocery"	DATE	GRAD	OUN	
Banks: 1st National Bank	2/13	X-E		

Credit Information Card

Watching the Accounts

Keeping in touch with the condition of his customer's account is another important detail of the credit man's work. Various methods are adopted by different houses. The one I have found most effective is to have on my desk a list of all live customers' accounts, that is, of all those who owe the house anything. This list is arranged first by territories, either salesmen's or collectors' territories. In the case of salesmen the lists are made out alphabet-

COLLECTIONS

MADE BY..... 191....

CASH AND CHEQUES	Over	Short	LIST ALPHABETICALLY	CREDIT
Gold				
Dollars				
Halves				
Quarters				
Dimes				
Nickels				
Pennies				
Currency				
Cheques				
Total				
Remarks:				

Collector's Report

ically as to towns, and likewise as to customers' names in those towns.

In the cities, collectors are employed, and each has a territory, which is divided into five parts—one for each day from Monday to Friday. Every day the collector turns in the list of all the customers he has called on, with notations against the names of any who have not paid, giving the reason as stated by the delinquent customer. Saturday is given over to a general round-up of those who were absent when called on during the week. A glance over the list of customers for which one of these collectors is responsible will give you a fairly accurate idea of how closely he is following up the accounts. (See page 37.)

The Ledger Account as a Credit Index

As a further help in passing on orders, the heading of each ledger account should show the mercantile agency ratings and dates of same, with the terms and limit allotted by the credit department; and the bookkeepers should be instructed to notify the credit department if any customer is exceeding his limit. Constant reference to customers' accounts is absolutely necessary if the credit man wishes to be a success; and he should be in a position at any time to tell approximately what a customer is owing (especially those who are not rated as absolutely good for all they may order), even without consulting the ledger account. (For bookkeeper's report see page 39.)

Importance of Prompt Collections

Time is a great factor in credit, and the merchant of today has to work on a smaller margin of profit than he did years ago. He must therefore turn over his capital oftener, and to do so must curtail his time limit to his customers whenever this is possible.

Date———————

Limit——— Time———

Credit Department:

Your attention is called to our account with:

Name———————————————

Address———————————————

No terms or limit.
Has passed limit.
Is 60 days old.
Is growing quite large.
Is out of line and needs attention.
Charges also coming through as

———————————————

———————Bookkeeper.

Bookkeeper's Report

The account of a slow customer is a bad asset, and such a customer also makes unfair competition for a good customer in the same locality. The man who pays promptly operates on his own capital; the man who is slow-pay and takes sixty to ninety days when he should only take thirty days, is operating on the jobber's capital. No credit man can claim the highest degree of efficiency until he collects his accounts as soon as they are due.

Routine of Collection Statements

Every effort should be made by the credit man to get his statements out promptly, for, with the smaller cus-

Collection List

STATEMENT OF COLLECTIONS

SALESMAN _____ WEEK ENDING _____ 191__

NAME AND ADDRESS	OWE	DUE	Date of Oldest Unpaid Bills	Salesman's Remarks, If Account is not Settled, Why and When will it be paid	TERMS

NOTE: This statement must be attached to your weekly expense report and mailed or delivered to this office every week. Remarks column to be filled in with complete notations opposite each item listed, if paid or why same is not paid, and when it will be.

THE CUDAHY PACKING CO.

tomer especially, it is a case of first come, first served, and payments are made accordingly. It is claimed by some that the weekly rendering of statements involves too much work, but in this I cannot agree.

In order to have the collection system work satisfactorily, it is sometimes arranged that the bookkeepers shall make out statements on a systematic schedule—on Wednesday of each week, all ten-day, fifteen-day, thirty-day, and sixty-day accounts are turned over by the bookkeeping department to the credit department; on Friday and Saturday, all weekly accounts, and on the first of the month, all monthly accounts. These are sorted and listed. The form we use for this "Collection List," as it is called, is shown on page 40.

All statements and all collection lists are made in duplicate, the original statement going to the customer, while the duplicate statement and original list go to the salesman or collector, and the duplicate list is kept in the credit department.

This list keeps the salesman informed as to which of his customers are owing past-due bills, which he is expected to collect. Where customers are more than usually delinquent, letters are written to the salesman, calling special attention to the delinquency. At the end of each week the salesman attaches to his expense account the list furnished to him, on which he has noted the result of his efforts. (See page 42.) These are carefully recorded, and, if promises to pay on certain dates are shown, the salesman is reminded of these dates on his next list, or, in certain instances, a letter is written direct to the customer.

Routine of Collection—Incoming Mail

Many credit men handle all the mail as it arrives; but in large houses this is impracticable. Our method is to

SALESMAN'S REPORT ON UNCOLLECTED ITEMS:

THE CUDAHY PACKING CO.

GENTLEMEN:--

HAVE BEEN UNABLE TO MAKE COLLECTION FROM

.....

.....

FOR THE FOLLOWING REASONS:

.....

.....

.....

.....

.....

.....

.....

.....

.....

(SALESMAN)

DATE.....

Salesman's Report

sort city from country mail as nearly as can be done by the postmarks. It is then opened by different clerks, who sort out orders and remittances first. The former go to the order department, and the remittances to the credit department, where notations are made of them on the collection lists. All remittances having deductions of any kind are referred to the claim clerk for adjustment, the remainder going to the cashier for entry. By this time the orders, properly written up, begin coming in from the order department, and the passing upon and OK'ing for shipment begins.

In this way all remittances are entered on the credit department collection lists, and the credit man knows at once, without having to consult the ledgers, how customers are paying, who is discounting, who is not, who pays drafts, etc.

Routine of Collection — Outgoing Mail

All copies of letters to customers relative to their accounts, are carefully filed to come up from three to five days later, allowing sufficient time for the mails to bring a reply. If no reply has been received, notice of draft is sent or draft itself made. These come up in rotation, and if the account is still unpaid, the next step is left to the judgment of the credit man—another letter, threat of suit, etc., etc.

Arrangement of Ledger Accounts

There are certain lines of business where a card ledger system for keeping the accounts of customers is undoubtedly good; but in a business having a large number of accounts, it is, in my opinion, impracticable, and the loose-leaf ledger system preferable.

The form and arrangement of ledger sheets are of

prime importance to the credit department and should be given careful consideration.

There are four general ways of arranging the ledger, one of which is in use by almost every large house.

(1) The straight numerical arrangement requiring an index, and lacking efficiency by reason of the necessity of continual reference to same.

(2) Arrangement according to salesmen's territories, the sheets in each territory being assigned a certain set of numbers. While this arrangement has some features to commend it, it again involves the use of an index.

(3) Territorial arrangement, in which all the accounts in each state are arranged alphabetically according to the towns and cities of the state, the individual accounts being arranged alphabetically under the name of the town. This arrangement necessitates an index, but it is rarely used, as practically every order gives the address necessary to locate the account. It facilitates statistical work regarding the volume of business from any one town, and enables the credit man to see what accounts are to be given preference at any point; and it is therefore strongly recommended.

(4) An alphabetical arrangement according to customers' names, which is recommended by many credit men and is particularly suited to certain lines. This would be my own choice.

Credit Insurance

There are companies which insure jobbers and manufacturers against credit losses, but I am not altogether favorably disposed to this class of insurance. In the first place, the usual method of such a company is to base the initial loss the manufacturer must stand on the percentage of loss sustained for five years previous. This is regarded

as the probable or certain loss, and they insure the losses above that amount. This is scarcely equitable, as in some years abnormal losses are sustained, which would raise the "probable loss" to a point which may never be reached again. My principal objection, however, is that the credit man, with a knowledge that his losses are insured, is apt to allow his judgment to be deadened, and "take a chance" which he would otherwise have refused.

Bad Debts

There is one thing the credit man should under all circumstances endeavor to avoid, and that is "Bad Debts"; but unfortunately he gets them; and his work is not ended when he writes off an account to his Suspense account. (The Suspense account contains a list of all bad and doubtful accounts, and, with some houses, all accounts that may take an indefinite time to collect.)

I keep particulars of all such accounts in a separate folder, containing everything pertaining to the case from the time the customer became insolvent, duplicates of the bills, with receipts for same attached, together with any information as to property the debtor has or is supposed to have. Knowledge of the debtor's whereabouts is always at hand, and from time to time efforts are made to collect. Frequently arrangements can be made for the payment of small sums weekly or monthly, and the account can be gradually collected in this manner.

In addition to the folder I keep a suspense ledger in which is entered the amount of debt and payments received thereon. This ledger should be kept by the credit manager himself or his assistant.

Even in cases where the debtor compromises and receives a release in full, I have frequently been able to collect the balance of my account when he resumed busi-

ness or inherited property. Such cases are, of course, rare, but still they show that it pays to keep in touch with the suspended or bad debt accounts; and I strongly recommend all credit men to give these suspended accounts all the attention possible. Results will show the wisdom of this course.

Securing Accounts

Before closing I desire to call attention to various methods of securing an account:

(1) By guarantee of some responsible party, for which two suitable forms are submitted.

(2) By a guarantee which includes a financial statement of the guarantor, making the guarantee that much more binding on him.

(3) By a simple guarantee.

Los Angeles, Cal., ————

To *(Name of Creditor)*

For value received, I hereby guarantee the prompt payment to THE CUDAHY PACKING COMPANY of the account of ————, which is or may become due them, to the extent of $————, hereby waiving notice of the extension of credit or delinquency of payment.

This guaranty to continue until revoked by me in writing.

————————

For the purpose of making the above guaranty acceptable to THE CUDAHY PACKING COMPANY and to obtain credit thereunder for ———— above named, I hereby state that I am the sole owner of personal property to the value of $———— and real estate property in the name of ————, located at ————, in the City of ————, County of ————, State of ————, valued at $————, encumbered for $————, and that I am worth over and above all debts and exemptions not less than $————.

————————

Guaranty of Payment (Form 1)

Guaranty of Payment (Form 2)

THE CUDAHY PACKING CO.
SOUTH OMAHA, NEB.

FOR VALUE RECEIVED, and in consideration of THE CUDAHY PACKING CO., selling and delivering to.....of.....such meats, provisions, and other of their products as.....may order from time to time,.....DO HEREBY GUARANTEE the payment to the said THE CUDAHY PACKING CO., at maturity of bills, or at any time thereafter on their demand, for all such purchases made by the said .....during the period of .....years from the date hereof, to the amount of .....DOLLARS.

That.....guaranty herein expressed is for a running account against the said..... and is a continuing guaranty for the payment of any sum, or sums, owing thereon to the aforesaid sum of .....DOLLARS. Hereby waiving notice of acceptance of this guaranty, notice of maturity of purchases, and default in payment. It is expressly understood that any indebtedness of the said .....to THE CUDAHY PACKING CO., over and above and in excess of the aforesaid sum of.....DOLLARS is at the risk of THE CUDAHY PACKING CO., but such additional indebtedness will not alter or vitiate.....guaranty expressed for the said sum of .....DOLLARS.

Dated at.....this..... day of.....19 ....

Witness:

.....[SEAL]

Guaranty of Payment (Form 3)

FOR VALUE RECEIVED, and in consideration of such sales as **The Cudahy Packing Company,**.....
(hereinafter designated as Seller) may hereafter make to.....
(hereinafter designated as Purchaser) of the City of....., the undersigned (hereinafter designated as Guarantor) jointly and severally **does** or **(do)** hereby guarantee the prompt payment by Purchaser to the Seller at maturity of bills for all purchases made by said Purchaser from Seller during the period of.....years from the date hereof.

1. It is specifically agreed that the guaranty herein expressed is for a running account against the said Purchaser and is a continuing guaranty for the payment of any sum or sums owing thereon at any time, but not to exceed a liability against Guarantor for any unpaid bill or bills beyond or above the aggregate sum of.....Dollars.

2. Any indebtedness of Purchaser to Seller over and above the maximum liability as above stated is at the responsibility of Seller so far as the Guarantor herein is concerned, provided, however, that any collection from Purchaser or from other security shall not reduce Guarantor's liability for unpaid bills within the above limits.

3. It is understood that this guaranty, if signed by more than one party, is the joint and several obligation of each, or, if other guaranties are taken, may be taken as the several obligation of any Guarantor.

4. Notice of acceptance, notice of maturity of purchase, and (or) of default in payment and all statutory exemptions are hereby expressly waived.

5. In the event of this guaranty being signed by a married woman, it is agreed that same is made upon the faith and credit of her sole and separate estate, and includes any and all liability which she may legally assume.

Dated at..... this.....day of..... 191...

Witness

.....[SEAL]

The bill of sale and the fixture lease under the California law, may also be mentioned. The bill of sale of a stock of merchandise or fixtures is only binding when possession is given. The bulk sales law provides that the sale of a stock of goods must be advertised for five days. This does not apply to fixtures. The fixture lease is an arrangement by which fixtures remain the property of the lessor until payment of the purchase price has been made. Usually the lease provides for monthly payments until the total sum agreed on has been paid.

CHAPTER III

BANK CREDITS

By J. M. Elliott

Bank Credits Defined

Credit is defined by the dictionaries as: "The degree of confidence in the ability and disposition of a person, a firm, corporation, or government, to meet its financial obligations." This is the correct definition of the word from the standpoint of the bank, though the expression also means the permission given by a bank to a certain individual to draw upon it for a given amount. This permission sometimes takes the form of what is called a "Letter of Credit."

Good judgment in bank credits is the ability to determine whether the loan requested is going to be repaid with interest. To the credit man that is his only concern in the matter; and the ability to find out that one thing beforehand is the distinguishing characteristic of the good credit man.

"Changes and Chances"

There is an expression in the Episcopal Prayer Book which every man in the banking business, as a lender, should have always in mind; and that is—"the sundry and manifold changes and chances of this mortal life." A man comes and asks for a credit. He is in full health—in the full possession of all his faculties. He looks as if

he would go on indefinitely; but, when he tells his story of what he wants that money for, and just what use he can make of it, and how he expects to return it—there being apparently no flaw in his explanation—you must, as you listen and decide, keep that phrase in your mind.

Credit Applications — Professional Men

Many men think that they have credit, or that they should be entitled to it, when they are not. I will take as an instance a professional man. He makes a statement to you of what he is worth and what he owes. This, of course, is the first thing to have before you in determining whether the credit is a good one or not. He says that he has $500 in the bank that he can draw upon at any time; that he has due to him for professional services, say, $2,500; that he owns an automobile which cost $1,200; and in addition to all this, 10,000 shares in the Blue Sky Oil Company—which, however, he has to acknowledge has forfeited its lease, making the shares not very good as collateral. He also has a house, a home, which stands in his own name, and in which his family resides, worth $6,500, and all the usual tools of his trade. If he is a surgeon, he has perhaps instruments worth $500. One thing more he has, and that is life insurance upon which he is paying $499 a year in premiums, and which is payable to his estate when he dies. On the other hand, he owes, say, $1,200 or $1,500 on different bills, and he wishes to borrow $1,000 to pay these bills.

The first item, $500 cash in the bank, is a good basis of credit. The next item, however—the $2,500 of professional credits due to him—would shrink, were he to die, to a very small sum. He will tell you, if closely questioned, that a great deal of it is past due, and that he has absolutely made up his mind that he is going to lose at

least half of it. As to his automobile, it is a considerable expense, and bankers frequently think of an automobile as a liability instead of an asset. But he has his house, worth $6,500, and his professional instruments worth $500, and his life insurance, which will go to his estate when he dies, and which would pay his debts.

The first thing to tell this man is that the law makes his home, to the amount of $5,000, absolutely exempt; and that all that his wife has to do when the sheriff has his hand raised to say "Gone" to a bidder, is to put in a little paper which reads "Homestead," and that sheriff's hand is suspended.

The law says also that the instruments which he owns are instruments of his trade, and that they are not subject to execution.

There is, of course, his life insurance to levy on in case of his death. But the law steps in again and says that any life insurance bought at a rate under $500 a year belongs to his wife when he dies, no matter whether it is decreed to go to his estate or not.

Therefore, all that you have to depend upon for the repayment of that loan is the $500 in the bank, which he may spend at any time, and whatever could be recovered from the claims he has against patients for work done. But there is still another question which you have to take into consideration. Suppose that man is injured severely, or that he has a grievous illness which continues for some time. He has to pay the $500 or the $499 a year to keep up his life insurance. Don't you see that he will sacrifice nearly everything he owns in the world in order to keep up that amount of life insurance for his wife and children, and that he will let his creditors go?

That is a sample of what bankers have to consider when they have a credit application before them.

Credit Applications—Corporations and Partnerships

When the application comes from a business house, of course the matter is entirely different. We ask the same questions, but we ask a great many more. As you know, a majority of the business houses in this country are run as corporations, though often these corporations are owned by a very few people. This is done on account of the disadvantages of partnership; for when a partner dies, his estate may have to pass through much legal controversy in which the partnership is more or less involved, whereas, if one of the holders of the stock of a corporation dies, the stock only goes into his estate, and the corporation is not necessarily interfered with in any way.

There is a difference also in the liability for debt. Each member of a partnership is liable for the entire debt of the firm, while a stockholder at the worst is liable for the debts of the corporation only in proportion to the amount of his stock, and in most states is not liable at all. For this reason, when a corporation is in the least doubtful, banks require that its paper shall have the indorsement of the persons most strongly interested in it. When this is refused it is an evidence that these gentlemen are a little afraid of the corporation; and the bank is fully justified in saying "No" to the application for credit.

Sometimes there are four or five of the members of the board of directors who are willing to indorse, but the other man, being exceedingly careful, or perhaps a little crabbed, says he will not. A bank must then use its judgment as to whether it will take the names of the four.

Sometimes there is one man among the directors who is known to be absolutely good for any contract that he may make; and the bank says to him, "If you are willing to indorse this paper, we will take it." Sometimes he will, and if he does the bank has good security.

Form of Indorsement

I may mention here one rather important little technicality. A man who indorses his name upon a note is liable upon it until that note is due; but then, if the note is not protested—that is, if an official notice is not sent to him that the money has been demanded from the maker and the maker has refused to pay it—his liability is questionable, and may be worthless. In order to be sure that this does not occur, careful banks have the indorsement made upon the back of that paper twice; near the top where there is nothing above it, and in the center of the note, under the stamp which says: "For value received we jointly and severally hereby guarantee the payment of the within note, hereby waiving presentment, demand, and notice of non-payment and protest." When this is done the indorsement is a guarantee of that note as long as it lives, that is, up to four years.

I have seen a case illustrating this point. One indorser, after the five names had been signed, wrote in above them a guarantee similar to the form quoted in the preceding paragraph, then took the note to the bank, where it was accepted. The other four directors afterwards claimed that when they signed their names the guarantee was not on the note, and that they were entitled to have notice of protest of the note when due, that having no such notice they had reason to believe the note paid, and that therefore their liability had ceased. The law upheld this contention as to the four, and laid the burden on the one man who had made the false record.

Indorsement of the Board of Directors

In California a loan made to a corporation without a resolution of the board of directors authorizing the president and secretary, or some of the officers, to sign the note,

is only good against that corporation if the bank can prove that the corporation itself obtained the benefit. Even in this case there can be no interest collected. Most banks, therefore, provide a form to be filled out by the officers of corporations asking for loans; and this form calls for the formal sanction of the board of directors.

But there are times when a corporation, for some reason, cannot have a meeting of its board of directors; and in such cases it has been my custom to change the form of guarantee thus: "We, the undersigned, jointly and severally guarantee the validity as well as the payment of the within note." I have never known that form of guaranty to be broken, and, consequently, I think it is good, for it holds the officers personally responsible for the performance of the act by the corporation. The California law requiring the resolution of the board is only a reminiscence, a reminder of early times, fifty years ago, when mining corporations could borrow anything that they felt like and give the notes of the corporation for it. The law was passed to prevent this; but in other states, corporations give notes bearing merely the signatures of their officers, which are good against the corporation.

Corporation Statements

We will suppose, however, that the corporation applies for a loan in proper form, and is asked to make its statement to its bank. It says it has $5,000 in bank; it has $100,000 worth of merchandise, reckoned at cost price without adding any profit. It has $100,000 of good accounts on its books for goods sold and delivered not more than 60 or 90 days previous, the bills for which are not yet due. It has, say, $5,000 of older accounts which have now passed into the category of doubtful paper. It owns real estate worth $25,000.

On the other hand, it has a debit of $50,000 to its bank, and $50,000 to persons and firms for merchandise.

Quick Assets Must Exceed Liabilities

In passing on such an application, the first step is to compare the quick assets of the firm with the quick liabilities—that is to say, the debts due with the money available. All liabilities, with the exception of bonds and mortgages, may thus be termed "quick"; but quick assets include only cash, and property which can promptly be exchanged for it. Solvency depends upon a supply of such available assets sufficient to meet the demand.

For instance, accounts receivable for goods sold to reliable firms would ordinarily be considered quick assets. But these should always be much in excess of the quick liabilities, for in times of panic they cannot be realized on with certainty. Still, the good customers will force their goods out and meet their liabilities. Bankers will remember that in 1907 a great many persons sold their goods without profit in order to come to the assistance of the banks which had favored them in the past, paying off a considerable proportion of their indebtedness, whether or not it was due. Here again we see the importance of the personal element in credit granting.

Real estate and buildings can never be considered quick assets. The capital stock of a corporation, on the other hand, is not a quick liability, because the persons subscribing for the stock cannot withdraw their money, at least until the company is liquidated and all the debts are paid. Furniture and fixtures are slow assets; and the machinery in a manufacturing establishment is an asset so very unavailable that 10 to 25 per cent per annum should be allowed on the books for depreciation, if its value is to be fairly stated.

A Good Statement

Now, in the case under consideration, the corporation has $5,000 in the bank, which is an absolutely quick asset. It has $100,000 due from merchants who have purchased goods from it, and its treasurer can confidently judge by his past experience what proportion of this will be paid within 60 days—say 95 per cent. In 60 days, therefore, the representative of the corporation, with his $5,000 in the bank and the $95,000 that he may reasonably expect to receive, will be able to pay every dollar that he owes. Such a man can come to the bank with his statement, and can confidently expect, if he has treated the bank with proper liberality, that he will get $50,000 on the strength of the name and reputation of his firm, or of the corporation which he represents.

In making a decision as to what an applicant's credit is worth, it is, of course, necessary to take up the quick assets first. If there are a number of fixed assets back of these, it naturally increases the value of the loan and makes it still more secure.

A Doubtful Statement

But all corporations are not like the one just described. Suppose a corporation has $5,000 in bank, and $100,000 of credits, $50,000 of which have come in within the last 60 days, while the other $50,000 have been on the books from 90 days to a year or two. When the merchandise represented by the $100,000 on the applicant's statement is examined by the bank (which in this instance is careful to find out the value of the merchandise on hand) a large part of it is found to be old stock, the whole being put in at a price in excess of its cost. Nevertheless, this merchant thinks himself strong.

The bank loans him $20,000 or $25,000, with considerable doubt, and if that $25,000 is not paid, it looks into the condition of the report sent in about every six months. If the corporation is not showing a steady decrease in the bad paper on its books, and an equally steady increase in the good paper—if the merchandise on its books is not put in at its real value, and the worthless, or nearly worthless, stuff disposed of—that $25,000 will be called by the bank.

Credit Applications—The Retail Man

Now, if the applicant for credit, instead of being a corporation, is the owner of a retail store—a drug store or a grocery—the application must still be handled on the same basis. But we must lay even more emphasis upon the personal equation—that is, we must ask if the man running the store is likely to make a success. This personal factor is one of the things that a bank must always consider. If it lends to a man who is unsuccessful, and who has virtually proven himself to be unsuccessful, it is taking a very much greater risk than it is with a man who has no better material basis for credit, but who has another great basis for credit within himself—the ability to succeed. The Spaniards have a proverb which says: "When an unlucky man becomes a hat maker, his children are born without heads." There are some people who are very unfortunate by nature, and it has hurt my heart many and many a time when I have told them that notwithstanding the statement they made, the bank could not and would not advance them anything whatever. Such a person is impossible to describe, but, somehow, that man will make some admission in talking to you which will give you a clue; and after a further examination of his characteristics, and of his lack of success in the past, you

will see that he is a man whom it is absolutely impossible to help. In such a case it would not even be real humanity, much less good business, to make a loan.

The Personal Element

Banks take the statements of their customers year by year, or period by period, and analyze them. Parallel columns show what the condition was in 1909, in 1911, in 1912, and in 1913, and the evidence of prosperity thus obtained means that the firm's credit is increasing, whereas, if the account is unfavorable and shows that it is not making its way, that credit has to be cut off.

Bank men, however, cannot be altogether cold-blooded. It would not be wrong to say that they must exercise a great deal of human kindness, and a great deal of human discernment. The banker who is absolutely cold-blooded and hard in all of his dealings is not a success. In considering any application for money every circumstance connected with it must be carefully weighed. Sometimes one man can get credit when he is seemingly less worthy of it than another man, because of circumstances connected with the application which make it wise for the bank to take a little risk. Again, a man keeps an account with a bank for years, and is straightforward and friendly in his dealings with it. Owing to a change in his affairs, perhaps due to his having signed notes for other people, perhaps to trouble in his family, or to some other accident, that man has to come and ask for a larger credit than he is entitled to. If he is honest, he should have it. The bank that makes such little differences, and recognizes the personal element, is the one that succeeds.

The officers of such an institution should also be quick to recognize ability and foresight, and economy in personal affairs, on the part of young men just starting out,

and should help such men, conservatively, of course, never advancing any large amount. By making themselves, as it were, advisers and elder partners for a time, they help to make these men and to build up the great institutions of a city, and in doing this they gain the eternal friendship of those whom they have befriended.

But though all this is true, sympathy must not be allowed to overrule judgment. The bank officer who forgets this is not a safe man to be intrusted with other people's money. He has to walk along a very narrow path with dangers on both sides; and if any man has ever found out the way of absolutely marking down that path with a line, I have never seen him, nor have I had the pleasure of reading what he has done.

Collateral

But sometimes men who are customers of banks come in and say, "I am in want of a loan, I am one of your customers, and I have this collateral." You do not have to ask such a man for a statement. He says, "I don't care to give you a statement of my affairs. You can see from your books what kind of an account I have kept with you. I have kept an average balance of $1,500 or $2,000. Now I want $20,000 for a short time, and I want you to carry $10,000 for three months, and $10,000 for six months, and I should be glad to have you look at this collateral." Then the bank officer must exercise his discernment as to the value of the collateral. Business men do not have the best collateral, such as government bonds, state and county bonds, municipal bonds. On such bonds banks will, of course, make a loan of 95 per cent at any time and be sure that they are all right; but more frequently the borrower comes in with some Union Oil Stock, or some Edison Preferred, and a number of other stocks

which must be criticized and scrutinized. The banker must know something about the management of the corporations represented by this stock, and the conditions upon which the stock or bonds are issued; whether the real estate that the corporation owns is clear; whether it has paid dividends for a number of years and seems likely to do so. If all these questions can be answered satisfactorily, that stock is good, provided it does not belong to a private, or what is called a "close," corporation.

Stock brought in as collateral may seem to be perfectly good, but just as careful an analysis should be made of the affairs of the company which issues that stock as is made of the affairs of any corporation which is borrowing directly from the bank. It should be ascertained, first, if the real estate which represents a certain proportion of the assets is mortgaged. If it is mortgaged, you are merely taking a part of a second mortgage as collateral, and the man who takes a second mortgage must always be prepared to have the holder of the first mortgage come and say, "Will you pay me, or will you lose your second mortgage?" A bank which takes collateral of that kind must always remember that it is running this risk, and that, as a general thing, it is entirely unsafe to do so.

The Close Corporation

A close corporation is one in which the stock is owned by a very few people. It is generally a business firm which has, for reasons of convenience, incorporated; and sometimes there is one man who owns nearly all the stock, but has put one share each into the names of two or four members of his family who act as directors. That is the closest kind of a corporation; but the California law allows a corporation to be created with only three directors, and thus makes it possible for two members of a firm to form a

corporation, and divide the stock between them (with the exception of two or three shares allotted to some member of their own family, or perhaps to some trusted employee, in order to have the necessary number of directors), and such a corporation is almost as close a corporation as the one already described.

A close corporation of a somewhat different nature is formed when a person conducting a handsome business which has been assisted very materially by the upper clerks, or by the heads of departments within his employ, says, "Gentlemen, I am going to turn this into a corporation. I am going to issue 98 per cent of this stock to myself, because I own the business; but you, Mr. Jones, have been with me for five years, and you have managed your department well, so I am going to put $5,000 of that stock in your name, and have you indorse it and return it to me, and give me at the same time your note for $5,000; and I will carry that for you for a reasonable number of years, and let you pay it off as you please." In the meantime, of course, Mr. Jones gets the dividends on that $5,000 worth of stock, and the harder he works, and the greater success he makes of the business, the better for him, because he is one of the participants.

The employer may divide up as much as a quarter of his stock among four or five trusted employees, who thus become his partners in a small way; and as he gets older and the younger men take on more of the business, they will perhaps buy from him other shares of the stock. In such a case it can hardly be called a very close corporation, because these younger men are in the market for any stock that may be thrown there. When a corporation has passed this stage the market for its stock gradually increases, more and more persons being interested in it; and if any of the stock has to be taken by the bank for debt,

there is always someone who will buy it—provided, of course, that the corporation is a success.

Now you see why a bank cannot loan on the stock of a close corporation. Such stock has no general market; and if, for any reason, the holder of the stock has to take it for the debt, the only persons to whom he can sell it are the other members of the close corporation. If they do not choose to buy it from him, he is helpless. These things all have to be considered.

New York Rules

Banks in New York have no such rules in regard to the collaterals that they may accept, but merely require a certain proportion of bonds, and a certain proportion of stocks to be listed on the Exchange; and the money is loaned from day to day on such collateral. But as you get away from New York and into the smaller places, there is less and less market for any stock; and the market in such a small city may at any time be glutted by an amount of some stock a little over the ordinary thrown upon it. This also has to be considered, and a banker who would loan up to 90 per cent of the value of collateral in New York, could not loan more than 75 per cent of that value in a place as far from New York as Los Angeles.

CHAPTER IV

FINANCIAL STATEMENTS, THEIR FORM AND ANALYSIS

By Herman Flatau

In the discussion of financial statements which follows, the writer is referring only to such statements as come to the credit man of a manufacturing or wholesale establishment, either direct from applicants for credit, or through the commercial agencies. A few words on credit methods in general may, however, help to make clear the importance of this subject.

Credit Methods of Banks

As was stated in the preceding chapter, banks have a well-established rule which requires of an applicant for credit a written statement of his financial condition with his application for a loan. As a rule, the merchant who wishes to borrow money from a bank calls there in person to fill out this statement, and to answer such other questions about his business affairs as the president or cashier may wish to ask him. Thus the banker has the opportunity of coming into personal contact with the applicant, and of receiving from him direct a signed statement and such other information as is necessary, *before* he passes upon the credit risk.

Mercantile Methods

But the credit man of a wholesale house has no such advantage. He often receives an application for credit in

the shape of an order from a new customer, which his salesman sends to him with the injunction, "Rush shipment," and the brief financial statement, "This man is A—1."

Knowing the eagerness of his house to do as much business as possible, and being perhaps unable to get a report from the commercial agencies at once, he will often take a chance in filling the first order—provided, of course, it is not too large—upon the most meager information about the new customer's standing. Then, after the goods have been shipped, he will apply for a financial statement, not to the new customer direct, but through the commercial agencies.

By far the greater number of financial statements come through the commercial agencies; and while their service may not be perfect, the information they furnish as to the customer's antecedents and his known assets and liabilities, is of the greatest value and assistance to the credit man, and well worth the price paid for the agency service.

Credit men do not, as a rule, apply for a statement to the new customer direct, for the reason that he will often take such a request as a reflection upon his character and honesty. There are several causes for this attitude on the part of the customer. One is that some of those engaged in the retail trade have little knowledge of proper business methods; and another, that, on account of the limited territory to which the wholesaler's business is usually confined, the retail merchant is visited every day by many salesmen representing the same line of goods, who are eager to sell him on the most favorable terms, and under these circumstances he resents the inquiries of the wholesale house. Still another, and perhaps the principal cause of the credit man's reluctance to make direct inquiries as to

the new customer's standing, is due to the lack of understanding and confidence among credit men, complicated by the fear of losing a new customer. That there are comparatively few losses, even with such loose business methods, speaks well for the honesty of the men engaged in the retail trade.

However, the steady growth of competition has a tendency gradually to decrease profits and increase expenses; therefore, in order to make a net profit, the percentage of losses from book accounts will have to be reduced, and the credit man of a wholesale house will in time be compelled, like the banker, to demand a correct financial statement before the granting of credit is considered.

Ordinary Forms of the Financial Statement

The ordinary financial statement is a list of all actual assets and liabilities at a given date, intended to show the true financial condition of a business. It is usually arranged in such form as to show all the assets—that is, all the personal and real property a firm owns—upon one side of the sheet, and all liabilities—that is, all the debts a firm owes—upon the other side. The total of each class of items comprising the assets is listed separately; as, Merchandise; Accounts receivable, good; Bills receivable, good; Cash on hand; Cash in bank; Fixtures; Machinery; Horses and wagons; Real estate; etc. The liabilities are also listed separately in the same manner; as, Owe for merchandise, due; Owe for merchandise, not due; Notes for merchandise; Owe banks; Owe relatives and friends; Owe for rent; Mortgage on real estate; Chattel mortgage on fixtures; etc. If the total amount of the assets is larger than that of the liabilities, the excess is the *net worth* or capital of the business. If the sum total of the liabilities

is greater than that of the assets, the difference is called the *deficit*. A statement thus *correctly* executed will enable the credit man to form a fair estimate of the financial strength of an applicant for credit.

Statement of the National Credit Men's Association

Now the object of getting a statement is to obtain such information as will enable the credit man to determine the credit, if any, to which a certain merchant is entitled. Experience, however, has shown that the mere knowledge of how much a merchant is worth in dollars and cents is not sufficient for safe credit granting, and that in order to act intelligently a credit man must have additional data.

The National Credit Men's Association recognized the need of a financial statement blank not limited to questions about assets and liabilities, but containing also proper and unobjectionable queries, calculated to elicit other necessary information. A committee of the most experienced members was appointed to draft such forms and present them to the National Association for consideration; and of the number submitted, six were indorsed and recommended by the Association. Two of these forms are here shown. The first is sent by a commercial house to be filled out by an individual or by a partnership firm, and the second is sent to corporations.

Both of these forms are prefaced by the following brief but forceful argument, urging upon the merchant the desirability of giving a signed statement, because in so doing he strengthens and adds to his credit, and also emphasizing the fact that a merchant's capital is really his resources plus his credit, and thus whatever adds to the latter is equivalent to an increase of capital.

PROPERTY STATEMENT BLANK

RECOMMENDED AND INDORSED BY THE
NATIONAL ASSOCIATION OF CREDIT MEN

THE RECIPROCAL VALUE OF A SIGNED STATEMENT

Good credit in the markets of the world enables every merchant to add to his ability to do business. It gives him the use of enlarged capital, thus enabling him to carry a more complete stock, increase his sales, and magnify his profits.

Large assets are not always necessary to the creation of credit; what is most desirable is, that credit be in relative proportion to the actual assets, and in harmony with conditions which create and maintain it. A merchant's capital is the sum of his net available resources, plus his credit. The giver of credit is a contributor of capital, and becomes, in a certain sense, a partner of the debtor, and, as such, has a perfect right to complete information of the debtor's condition at all times.

Credit is given a merchant because of the confidence reposed in him Requesting a statement when credit is asked is not a reflection on one's character, honesty, or business ability, but is done to secure information to enable business to be conducted intelligently.

When a statement is made it should be absolutely correct. To make it so necessitates the taking of at least an annual inventory and the keeping of an accurate set of books. Statement giving, therefore, will tend to make a debtor a better buyer, because more familiar with his stock, more careful in giving credit, more conservative in incurring debt, and will result in a better knowledge of his business generally.

A merchant who desires to serve his own best interests should recognize that his most valuable possession, apart from his actual assets, is a sound, substantial and unquestioned reputation as a credit risk, and that, under the prevailing conditions and demands of business, the most effective, and eminently the best way to prove his basis for credit, is to be willing to submit a statement of his financial condition.

NOTE: The above estimate of the value of a statement to both giver and receiver is the embodiment of the thoughts and experiences of scores of the leading credit men of the United States, who are members of the National Association of Credit Men, and who thus desire publicity given to their views in order that there may be the largest benefits to both retailer and wholesaler.

Property Statement (Prefatory page)

For the purpose of obtaining credit for goods to be sold me or us by you, or for any extension granted me or us on my or our account with you, the following is given you as a true statement of my or our assets and/liabilities and general financial condition. I or we agree to and will notify you immediately in writing of any materially unfavorable change in my or our financial condition, and in the absence of such notice, or of a new and full written statement, this may be considered as a continuing statement and substantially correct.

Firm name..... Date..... 191.....

Town..... County..... State.....

ACTIVE BUSINESS ASSETS	Dollars	Cents
Value of merchandise on hand at cost.....		
Notes and accounts, cash value.....		
Cash in hand.....		
Cash in bank.....		
Fixtures, machinery, horses and wagons.....		
Total Active Business Assets.....		

BUSINESS LIABILITIES	Dollars	Cents
Owe for mdse., open acct.		
of which $.....is past due		
Owe on notes for mdse.....		
Owe bank.....		
Owe others for bor'd money		
Owe taxes and rent.....		
Mtges. on fixtures, machin'y, horses and wagons.....		
Total Business Liabilities.....		
Net Worth in Business.....		

OUTSIDE ASSETS	
Total real estate, assessed valuation, $.....	
Total encumbrances.....$.....	
Equity.....	
Personal property.....	
Other assets.....	
Grand Total net worth in and out of Business	

Please state location and description of each parcel of real estate, and cash valuation of, and encumbrances on each, and in whose name each parcel is held.....

.....

.....

.....

.....

Form A.

Property Statement—Individual or Partnership (page 2)

What portion of real estate described is homestead?.....

Have you any other debts than herein mentioned?.....

Full given and surname of each partner	Age?	Married?	Possible liability of each member of firm as indorser, bondsman, etc.

What kind of business do you conduct?.....

Insurance on stock..... On fixtures, machinery, horses and wagons ..... On real estate..... ..... Amount of sales last year..... Amount of expenses last year..... What proportion of your sales is on credit?..... How often do you take an inventory of stock?..... Date of last inventory..... If you have borrowed money in the business, state what amount is secured and in what way..... ..... Are any merchandise creditors secured in any way?..... Have you any judgments, judgment notes, chattel mortgages, or other liens against you, recorded or unrecorded? If so, describe .... Suits pending and of what nature..... ..... If you have pledged or transferred outstanding accounts or property remaining under your control, state amount thereof and amount received, or to be received, on account of such pledge or transfer..... ..... Keep bank account with..... What books of account do you keep?..... .....

Buy principally from following firms:

Name	Address	What line of business?

The above statement, both printed and written, has been carefully read by the undersigned, and is a full and correct statement of my or our financial condition as of.....191.....

Firm signature.....

By whom signed ..... a member of the firm.

All questions must be answered, insert ciphers in absence of any amount. When the words "Yes," "No" or "None" will correctly answer the questions, write them in their proper places.

B-3.

Property Statement—Individual or Partnership (page 3)

To RICH, MANN & CO., New York

For the purpose of obtaining credit now and hereafter for goods purchased, we herewith submit to you the following statement of our resources and liabilities, and will immediately notify you of any material change in our financial condition.

In consideration of your granting credit to the undersigned, we agree that in case of our failure or insolvency, or in case we shall make any assignment for the benefit of creditors, bill of sale, mortgage, or other transfer of our property, or shall have our stock or plant attached, receiver appointed, or should any judgment be entered against us, then all and every of the claims which you have against us shall at your option become immediately due and payable, even though the term of credit has not expired. All goods hereafter purchased from you shall be taken to be purchased subject to the foregoing conditions as a part of the terms of sale.

Corporation style.....

City..... County..... State.....

BUSINESS ASSETS	Dollars	Cents
Value of Merchandise on hand at cost		
If manufacturing, raw material, $.....finished, $..... unfinished, $.....		
Notes and accounts, cash value		
Cash in hand		
Cash in bank		
Bills or accounts receivable, due from officers		
Patents and patterns		
Fixtures and machinery		
Total real estate, cash value.....$		
Total encumbrances on real estate, $..... Equity.....		
Total Active Business Assets		

BUSINESS LIABILITIES.	Dollars	Cents
Owe for mdse., open acct.,		
of which $.....is past due		
Owe for notes for mdse.....		
Owe banks		
Owe for bills for paper sold		
Owe others for bor'd money		
Owe taxes and rent.....		
Mtgs. on fixt's and mach'y		
Total Business Liabilities		
Total net worth		

Please state location and description of each parcel of real estate, and cash valuation of, and encumbrances on, each.....

.....

.....

Contingent Liability { Accommodation indorsements.....
Indorsed bills receivable and outstanding.....

OFFICERS.

Name in Full	Address
President	.....
Vice-Prest	.....
Secretary	.....
Treasurer	.....

DIRECTORS.

Name in Full	Address
.....	.....
.....	.....
.....	.....
.....	.....

Authorized capital..... Subscribed..... Paid in.....
How paid in: Cash, $..... Other property..... Description of other property, and how valued.....
..... In whose name is title to real estate held?
.....Incorporated in what State and under what general laws or special act?..... Nature of business?.....
Date of charter?.....Suits pending, and of what nature?.....
..... Are any merchandise creditors secured in any way?..... Amount of annual business..... Annual expenses.....
Annual dividends..... When was last dividend declared?..... Rate.....
Insurance carried on merchandise..... Fixtures and machinery.....
Real estate..... Regular time of taking inventory..... Keep bank accounts with.....
Keep following books of account.....
.....

If you have pledged or transferred outstanding accounts or property, remaining under your control, state amount thereof and amount received, or to be received, on account of such pledge or transfer.....
.....

Buy principally from following firms:

Name	Address	What line of business?
.....	.....	.....
.....	.....	.....
.....	.....	.....
.....	.....	.....

The above statement, both printed and written, has been carefully read by the undersigned, and is a full and correct statement of our financial condition as of .....191.....

Corporation Signature.....
By.....
Date.....

All questions must be answered, insert ciphers in absence of any amount. When the words "Yes," "No" or "None" will correctly answer the questions, write them in their proper places.

Property Statement—Corporation (page 3)

It will be noted that the corporation statement differs from the other in the character of the questions asked. These indicate how important and intricate is the organization of capital in corporations; and the facts intended to be elicited are of particular interest and importance to the credit man.

Reports of the Commercial Agencies

Now, while these statements contain considerably more information than the ordinary statement covering only assets and liabilities, yet, coming from the applicant direct, they cannot and do not enlighten us as to his own moral and mental make-up. For this information we generally look to the commercial agencies; and it is here that their importance becomes apparent to the credit man. The agency report is considered at length in another chapter.

The Credit Risk

Having now before us a standard form of financial statement, let us briefly consider the line of reasoning the credit man must follow and the business knowledge he must have in order to be able to analyze such a statement properly and reach a wise decision as to the giving or refusing of credit.

There is more or less risk in all credit transactions, and to discriminate between different degrees of risk is the difficult task of the credit man. If his duty were simply to avoid losses, then he would merely have to decline any account that was in the least doubtful. But this, of course, would reduce the volume of business of his house to a minimum; and since the ever-increasing competition cuts down profits and raises expenses, a wholesale house must do a certain volume of business every year in order to

show a fair amount of net profit. Hence, it becomes the duty of the credit man to secure the maximum volume of business with the minimum amount of losses.

Qualifications of the Credit Man

To be able to do this he must have experience and ability. He must be a good judge of human nature—able to form a correct estimate of those moral and intellectual assets of an applicant which are of even greater importance in determining the credit risk than are the financial assets. He must know how to analyze and to strike a balance of the moral and financial standing of a customer. He should have a good knowledge of accounting, so that he can detect the weak spots in a statement, and, if necessary, verify the figures by a comparison with the books of the applicant. He should have a fair knowledge of the laws affecting credits in the various states in which he is doing business, and should especially be posted as to the amount allowed under exemption laws. He should be fairly well informed as to values of merchandise, so that he will be able to approximate the amount of stock a merchant carries. Finally, he should be familiar with local conditions in the different places where his customers are doing business.

Character of Applicant

When we apply the rules of analysis to business, we find that success and safety are dependent upon the existence and proper combination of certain elements. Each one of these is an important factor in the consideration of credit, though some are of more consequence than others. Among the most important are the character, honesty, and habits of the applicant for credit; and deficiency in any one of these makes the risk dangerous. Therefore, the credit

man should carefully inquire into the personal record of the applicant. A man whose character is bad, who is dishonest, or who is addicted to drink, is not entitled to our confidence. We give a man credit because we have confidence in him, and we base our confidence in him upon his character, honesty, and habits; therefore, if these are not good, there remains no basis for credit.

Ability as a Credit Factor

But, though good personal character in an applicant is of the greatest importance to the creditor, this alone does not assure the success of a business. There are many cases on record where men of fine character and habits and absolute honesty have failed in business because of the lack of *ability*. Consequently, to insure the safety of credit transactions, the factor of ability must be added to those already mentioned. A merchant's ability is determined by the efficiency and the economy of his business organization; by his knowledge of the cost of goods; by his selection of the articles that his trade requires in quantities that will not overstock him; by the amount of business he does and the profit he makes; by judicious selling on credit and prompt attention to his collections.

If the credit man is absolutely certain of the existence of all these qualities in the applicant, he need but give passing notice to the items on the financial statement. In fact, many a merchant got his start upon no other assets but these. But, unfortunately, these moral and mental endowments are not always present in an applicant in such measure as to warrant the acceptance of the risk. And thus it is necessary to make a close analysis of the items comprising the physical assets and liabilities before reaching a final decision as to the amount of credit to be given.

Careless Bookkeeping

In making any such estimate of the net worth of a retailer it is well to bear in mind that some merchants are careless in their method of keeping their books, and that others do not keep any at all; thus the amounts of the various items on their statements are not always correct, and sometimes represent merely an *appraisal* of assets and liabilities. Therefore, when we have reason to believe that the statement received comes from a man who is careless in his bookkeeping, we must be more liberal in our allowance for shrinkage in the assets and for growth in the liabilities. Credit men have often had occasion to note the generous manner in which some merchants estimate the value of their assets, and how niggardly they are in stating their liabilities.

Valuation of Stock

But let us assume that the statement is compiled from books correctly kept. The first item for analysis will be: "Merchandise on hand at cost." In appraising the value of a stock with a view of granting credit, we must bear in mind the possibility of a failure, especially when the net worth shown by the statement is only of moderate amount. Experience has indicated that in cases of failure a stock consisting of staple goods, such as groceries, etc., located in a place where it can readily be sold, will bring from 60 to 75 cents on the dollar of invoice price. The stock of a going concern, of course, is worth more; therefore, an allowance of say 15 to 25 per cent on a staple stock will give us a conservative figure. But in considering the amount that should be deducted to arrive at a safe valuation, we must also notice the character of the merchandise, the condition it is in, whether it is slow-selling or can quickly be turned into cash.

Notes and Accounts

The next item is: "Notes and accounts." If we compare the amount outstanding with the amount of monthly credit business, we shall be able to judge whether the merchant is a close collector or not, and upon this will depend the amount that should be retired on account of age. At any rate an allowance of 30 to 40 per cent should be made for shrinkage.

Cash

The next item is: "Cash in hand." This, of course, is not subject to any depreciation if it consists of actual money, and not of checks that are dated ahead or have been returned on account of lack of funds. Then comes: "Cash in bank." In regard to this item, we must bear in mind the fact that, if the merchant is indebted to the bank where he deposits, such bank has the legal right to retain any cash or other personal property in its possession belonging to the debtor, and to apply it toward the payment of the debt.

"Quick" and "Slow" Assets

The foregoing items—merchandise, notes and accounts receivable, cash in hand and in bank—comprise what are generally called the quick assets, so named because they can be more quickly turned into cash than the fixed or slow assets, which usually consist of fixtures, store furniture, machinery, horses, wagons, etc. While these latter may, and often do, represent a considerable outlay of money, yet as a basis for credit their value should be considered nominal. A deduction of 50 per cent, at least, should be made.

Liabilities

Now, when we come to consider the liabilities, we know from experience that every dollar listed means 100 cents that must be paid, and often more than that. The amounts "Past due for merchandise" and "Owe on notes for merchandise" should be carefully noted, as these generally indicate unsatisfactory payments. An indebtedness for back rent, or a chattel mortgage on fixtures or horses and wagons is a sure sign of financial weakness.

Outside Assets

The various items heretofore mentioned are called the business assets and business liabilities. We now come to "Outside assets," such as, "Total real estate."

Real property, no doubt, strengthens the assets, provided it is free of encumbrance, stands in the name of the applicant, brings a fair return on the investment or is at least self-supporting, and is not subject to homestead exemption. Credit men are sometimes misled by the scheduling of a store building under assets, when as a fact the building is used for business and also for dwelling purposes, which latter fact brings it under the head of exemptions. If the real estate is mortgaged, the equity as a rule is not worth considering from a credit standpoint.

Personal Property and Other Assets

The next items, "Personal property" and "Other assets," are generally of such a nature as to be of little or no interest to creditors. The object of the other questions, such as: "What portion of real estate described is homestead?" or, "Have you any other debts than herein mentioned?" is, of course, plain.

Names of Partners or Officers

Then comes: "Full given name and surname of each partner." It is certainly of great importance to the credit man to know who is responsible for the debts of a business; therefore, he should carefully note that this question is satisfactorily answered. The name of the firm does not always indicate the actual person or persons interested in the business, and as each partner in a partnership firm is responsible for the entire indebtedness of the firm, it is well to know the name of each one. Some stores operate under an assumed or fictitious name, in some cases resembling that of a responsible business man. In order to safeguard credit grantors, a law has been enacted in some states requiring that every person or partnership conducting business under a fictitious name, or a designation not showing the names of the persons interested as partners in such business, must file with the clerk of the county in which his or its principal place of business is situated, a certificate stating the name in full and the place of residence of such person, and also stating the names in full of all the members of such partnership and their places of residence. If the business is incorporated, a complete list of all the officers should be obtained, together with a list of the number of shares each one owns, and, if possible, the names of other large shareholders. In some states each stockholder in a corporation is responsible for a percentage of the indebtedness proportionate to the number of shares he owns.

Personal Status

The next facts required are: "Age" and "Married." The age of a merchant is not an unimportant element in determining his claim for credit. After a man has passed his prime, his energy and ambition as a rule are on the

decline. If he has not been able to accumulate at least a fair amount of capital during the best years of his life, it is, with few exceptions, due to the fact that he is a failure as a business man. And again, if a man is very young, he lacks in most instances the experience which is necessary to conduct a business successfully. It is also important to know whether the merchant is married or single, for upon that depends the amount to which he is entitled under the exemption laws.

Insurance

The next information required is: "Insurance on stock, fixtures and real estate." Among the elements considered by credit men in determining the credit risk, perhaps none has received less attention than that of fire insurance. The ability of the retail merchant to pay his debts in case he suffers a heavy loss by fire, depends usually upon the amount of insurance he carries. If his stock, fixtures, or buildings are not sufficiently insured, or perhaps not at all, the loss, in the absence of outside means, usually falls on the creditors. The National Association of Credit Men, whose principal object is to improve credit conditions, has presented many articles on the subject of insurance in the Bulletin of the Association, and has thus gradually impressed upon its members the importance of knowing something about the amount of fire insurance carried by their customers. It has also urged upon them and upon the commercial agencies the necessity of persuading the retailer to protect his credit by carrying reliable fire insurance of sufficient amount. Considerable improvement in this respect has resulted from the campaign of education.

Sales and Expenses

The next information required is: "Amount of sales last year" and "Amount of expenses last year." By comparing the total of expense with that of the sales, we can judge if the expenses are in proper proportion to the average gross profits—in other words, whether the retailer is making a net profit. The merchant who keeps his expenses within proper limits is generally careful in all other matters. Then, again, a comparison of his average monthly sales with the amount of stock carried will indicate whether he is a careful buyer. Overbuying is often the cause of failure.

Credit Sales

Next comes: "What proportion of sales is on credit?" Many retail merchants get into difficulties on account of selling too much on credit in proportion to their business capital. The amount of their credit business should not be so large that they cannot meet their obligations when due.

Inventories

The next fact required is: "Date of last inventory." It is surprising how few of those engaged in the retail business seem to understand the importance of an annual inventory. A financial statement coming from an applicant who seldom or never takes an inventory cannot be reliable, as it merely represents a guess; but if he is in the habit of taking an annual inventory, the indications are that he is conducting his business intelligently. The careful merchant will want to know at least once in twelve months his exact financial condition, and his profits in proportion to the amount of business he has done.

The reasons for the other questions on the statement

are perfectly clear, and further comment is unnecessary. It should be carefully noted that the statement is properly dated and signed, as otherwise it is of little value, and entirely worthless in cases of fraudulent failure.

Character Comes First

When we have in this way carefully analyzed the moral, mental, and financial worth of the applicant, we come to the point when we must decide upon the amount of credit to which he is entitled, always remembering that, as before stated, the credit man must inevitably be governed almost as much by the moral and intellectual make-up of each individual applicant as by the amount of capital he has. Experience only, and a close study of human nature, can give us the ability to judge how far we may safely go. There is, however, one fundamental rule which will apply to all cases, and which credit men should always bear in mind when gauging the credit risk, and that is, that character and ability come first.

Legal Punishment for False Statements

The practice of exacting and giving property statements has become more or less established; and an effort is now being made to throw such sanctity about this instrument as will give the safety that credit granting demands. While every state has some form of statute for the punishment of offenders who obtain money or property by means of false pretenses or representations, such statutes have proved inadequate in most cases where the fraud was perpetrated in connection with a false statement of condition. Experience having thus shown that a special statute upon this particular subject is necessary, the American Bankers' Association and the National Association of Credit Men have joined hands to secure in every state a law

penalizing the giving of a written false statement, such law to cover all cases of the making of false statements to obtain property or credit in any form, whether such statements are made directly to the one from whom it is sought to obtain the property or credit, or indirectly, as to a mercantile agency, to be referred to by the merchant who sells goods.

The bill brought forward in the California State Legislature may be quoted as an illustration. It reads as follows:

AN ACT to punish the making or use of false statements to obtain property or credit.

(Wherever a Penal Code or Consolidated Law is in force, the following should be inserted as a section in its appropriate place. Where no such Code exists, the act may properly be enacted as a new act, entitled as above.)

Be it enacted, etc.

SECTION 1. Any person,

(1) Who shall knowingly make or cause to be made, either directly or indirectly, or through any agency whatsoever, any false statement in writing, with intent that it shall be relied upon, respecting the financial condition, or means or ability to pay, of himself, or any other person, firm or corporation, in whom he is interested, or for whom he is acting, for the purpose of procuring in any form whatsoever, either the delivery of personal property, the payment of cash, the making of a loan or credit, the extension of a credit, the discount of an account receivable, or the making, acceptance, discount, sale or endorsement of a bill of exchange, or promissory note, for the benefit of either himself or of such person, firm or corporation; or

(2) Who, knowing that a false statement in writing has been made respecting the financial condition or means or ability to pay, of himself, or such person, firm or corporation in which he is interested, or for whom he is acting, procures, upon the faith thereof, for the benefit either of himself, or of such person, firm or corporation, either or any of the things of benefit mentioned in the first subdivision of this section; or

(3) Who, knowing that a statement in writing has been made, respecting the financial condition or means or ability to pay of himself or such person, firm or corporation, in which he is interested, or for whom he is acting, represents on a later day, either orally or in writing, that such statement theretofore made, if then again made on said day, would be then true, when in fact, said statement if then made would be false, and procures upon the faith thereof, for the benefit either of himself or of such person, firm or corporation, either or any of the things of benefit mentioned in the first sub-division of this section:

Shall be guilty of a felony, punishable by (insert amount of fine, term of imprisonment or both).

Federal Decisions

The Federal Government has also entered into a vigorous campaign against those who are using the mails for sending false financial statements in order to obtain credit. A notable case of this kind was tried about a year ago in one of the Federal Courts in the state of New York. The charge was based upon financial statements of the defendant's concern signed by himself, and sent through the mails to a wholesale dry-goods firm and to the commercial agencies. The latter issued them to subscribers, and the subscribers in turn extended credit to the firm on the strength of these statements. A representative of the dry-goods firm exhibited envelopes in which he said the various financial statements of the defendant's firm had been received through the mails. Important testimony was given by an expert representing the department of justice, who showed that an examination of the books of the defendant's firm revealed an average difference of $65,000 between the figures of the firm's books and the financial statement of the firm's condition submitted to the creditors and commercial agencies. He reported that there was an apparent insolvency of $5,800.

The attorney for the defense pleaded that never before had a case of the kind been tried in any court; that the

indictment was founded on a postal law of 1873, which had been passed to stop frauds such as gold brick and green goods schemes, fake medical advertisements, etc.; and that no one at the time of the drafting of the law expected that it would be used against a merchant doing a legitimate business, who might have mailed a few financial statements which on analysis were found to be over-optimistic or exaggerated. He said that Section 215 of the Criminal Code of the United States has been looked upon by the legal fraternity all along as applying to fake mining schemes and get-rich-quick propositions, and that it would be a very dangerous matter to broaden the meaning of the law to include financial statements, which, if put to the test of expert analysis, might be found in a multitude of cases to be a shade more favorable than the actual conditions warranted, yet might be made by men unconscious of fraud, and entirely innocent of wilful intent to deceive.

In charging the jury, the judge who presided at the trial, in interpreting Section 215, said that, if it were the intent of the defendant to defraud creditors or those about to become creditors of his firm by making false representations, then it was the duty of the jury to bring in a verdict of "guilty"; that a false or misleading statement made through gross carelessness or lack of knowledge of figures to mislead others, in order to secure property belonging to others, is a false representation. The jury brought in a verdict of "guilty." In passing sentence of imprisonment for one year and three months in the Federal penitentiary, the judge declared that he wanted it generally known among those who were inclined to do as the defendant had, that there is a law and a certainty of punishment necessary for the public good and as a deterrent to others.

Section 215 of the U. S. Criminal Code under which the defendant was convicted reads as follows:

Use of Mails to Promote Frauds. The Criminal Code of the United States.

Sec. 215. Whoever, having devised or intending to devise any scheme or article to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, etc., shall for the purpose of executing such schemes or artifice, or attempting so to do, place, or cause to be placed, any letter, postal card, package, writing, circular, pamphlet, or advertisement, whether addressed to any person residing within or outside the United States, in any post-office, or station thereof, or street or other letter box of the United States, or authorized depository for mail matter, to be sent or delivered by the Post Office establishment of the United States, or shall take or receive any such therefrom, whether mailed within or without the United States, or shall knowingly cause to be delivered by mail according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such letter, postal card, package, writing, circular, pamphlet, or advertisement, shall be fined not more than one thousand dollars, or imprisoned not more than five years, or both.

CHAPTER V

COMMERCIAL AGENCIES AND REPORTS

By E. R. Purdy

Primitive Methods

By way of preface to the subject of mercantile agencies, it may be well to review briefly the history of these agencies, and the conditions which existed previous to their establishment.

There was a time when mercantile transactions were unknown, when every man—if he could—took what he wanted from his fellow-man under the simple law of plunder. Then, as civilization advanced there came the era of barter, which, however, involved no granting of time for payment, no question of credit. Exchange was in kind, commodity for commodity, and each transaction was as simple, brief, and individual as the swapping of schoolboy jack-knives.

The Beginnings of Commerce

With the development of the more civilized instincts of mankind, fostered by a growing recognition of the advantages of peace, there came a great advancement in all industrial arts, followed by an immense production of everything required to meet the demands of necessity, or to satisfy the craving for luxury. These conditions led to the establishment of trade relations between nation and nation, until gradually the system of barter disappeared, and in its place came a broader and more enlightened commerce.

Necessity of Credit

But even then, goods were, as a rule, delivered only for immediate cash, as is clearly indicated by medieval account books. However, as commercial relations became extended and complex, the necessity for credit was gradually forced upon those engaged in the larger enterprises; and while for centuries the credit methods employed were crude, yet by their use individuals and nations prospered and added greatly to the material wealth of the world.

Complexity of Modern Credit Relations

This condition continued with but little change for a long period; in fact, up to the time of the beginning of American development during the last century. At this time, the rapid growth of the United States and Canada, their great extent, the marvelous enterprise of the people, the resulting mercantile, agricultural, and mineral development, and many other related causes, all combined to produce conditions which had never before existed nor been possible in the history of the world. In connection with all this, the great geographical separation of debtor and creditor, the distance between commercial centers, and the length of time required for transportation, ultimate delivery of goods and remittances, imperatively demanded some system of investigation as a guide for extending credit. It is therefore not improper to say that the work of the mercantile agency in its present state of development and extension is a natural and logical evolution from a commercial necessity.

Early Credit Conditions

Previous to the late '40s, no intelligent and general system of reporting mercantile credits had been attempted.

There had been no scientific study of this most vital factor in our commercial progress; methods were crude; information regarding customers was too often obtained by creditors from untrustworthy or prejudiced sources and in a haphazard way; finally, the time limits of payment were irregular and marked by an unwise over-indulgence to debtors with consequent disaster to creditors. All this pointed so clearly to the need for better credit methods that the establishment of the mercantile agency was a natural sequence.

Growth of Mercantile Agencies

The credit methods employed in the early days of Bradstreet's would now be condemned. The ratings were at first merely published on loose sheets and distributed to subscribers. But in August, 1857, the first reference book published by a mercantile agency appeared. It was an annual, and consisted of only 56 pages, with ratings in certain stipulated lines in New York, Boston, Philadelphia, Pittsburgh, Cincinnati, Chicago, and St. Louis. Later, semi-annuals were published in January and July; and later still, what were called second editions, in March and September, in which appeared such changes as could be inserted without rearranging the forms. In due time, to meet the growing demands of trade, regular quarterly volumes were issued, in January, April, July, and October, including all changes and all new names, up to the approximate date of issue. The rating books now list almost 2,000,000 names.

Necessity for Credit Investigation

Credit is first of all based upon the personality. A man's own character, abilities, and energies are the basis

for credit, just as they constitute his powers in the business of life itself. It has been well said that, "the intercourse of society—its trade, its religion, its friendships, its quarrels—is one wide judicial investigation of character." Investigation of some sort is necessary for the establishment, maintenance, and protection of all that pertains to human interests—whether social, religious, or mercantile. Just as society protects itself by perpetual and diligent inquiry regarding the character, habits, and associations of its every member, so the mercantile world recognizes the need of investigation as to the character and responsibility of its membership. And this function the mercantile agency undertakes to discharge. It aims to be the clearing house of credit; to be the conserver of solvency on the one hand, and the active enemy of the dishonest trader on the other.

The chief advantage realized from the activity of the agency is that the information necessary for accurate judgment as to commercial credits is obtained through a number of varied and trustworthy sources—sources which would be entirely inaccessible to the majority of private persons.

Bases of Credit

As before stated, character is the first factor to be considered. Capital is desirable and even necessary, but without a solid basis of character laid by the business man himself, capital alone will not suffice. The individual's own statement, properly confirmed by the mercantile agency, must form the ground work of the credit report, and the value of this statement depends largely upon his personal character, just as his business success depends largely upon his personal ability.

Influence of the Agencies on Commerce

Capital, character and ability, all of them important requisites, would, however, be of little or no avail without the medium of the credit reporting system, which affords to the outside world the evidence it must have as to the actual existence of these qualifications. Wherever we find the credit agency flourishing there is also found prosperity and progress. On the other hand, wherever the credit agency is unknown or hampered by ill-advised legislation there is sure to be found an unregulated, feeble, and intermittent traffic.

This fact was well illustrated when some years ago a western state enacted some hasty legislation which made it practically impossible for a reporting agency legally to conduct its work in that state. Bradstreet's omitted the state from its rating books, giving in its place an abstract of the laws which had made such action necessary, and advising its patrons that no reports could be supplied on mercantile subjects in that state. Dealers and manufacturers, being thus deprived of the usual means of getting information as to the credit standing of the merchants of this state, greatly curtailed credits in that section, and in some instances refused the extension of further credit altogether, with the result that the legislature was urgently petitioned to repeal those particular laws. The petition was successful, as it was obvious that the effect of this legislation on the mercantile credit and prosperity of the state had not been carefully considered.

Nature of the Reports

The agency report of today is a summary of all the facts necessary for the information of the merchant, manufacturer, or banker who has to decide on the wisdom and

expediency of granting credit to the subject of the report. Full details are given; but with conciseness, with simplicity of language, and without any attempt at verbal embellishment; and the report is such as can be readily comprehended by any reasonably intelligent business man.

Methods of Collecting Information

The *modus operandi* of the agency in gathering its data and constructing its report is about as follows: The reporter or correspondent—according as the report is in the city where the agency has an office, or in the country—approaches the subject for a statement of his financial affairs. It should be borne in mind, however, that the agency representative cannot compel the subject to submit a statement if he does not see fit to do so. On the other hand, very many modern business men have been long since convinced, by the agencies and by their own necessities, of the desirability of submitting financial statements; and the number who establish their credit by this method represent a very large percentage of the total engaged in business. The credit man of today at once sets a mark against the customer who declines to make a statement to the agencies. If a merchant asks credit he owes it to the grantor of this credit to acquaint him with his ability to discharge the obligation at maturity; and the only logical way to do this thoroughly is through the agencies, which have the facilities for checking up the statement and testing its accuracy.

The merchant is also asked by the agency representative to state his former place of residence, as his previous record very frequently determines the degree of credence to which his financial statement is entitled. This antecedent record will relate the experience and qualifications of the subject, his manner of paying bills, whether or not he

failed or left any unsettled liabilities, his estimated worth at time of leaving, etc. Then trade opinions are secured, and authorities consulted who are qualified to pass upon such points as whether the merchant is commencing with reasonable capital for the venture; whether there is a good opening at the time and location for the line engaged in, etc., etc.

Form of Report

To illustrate more clearly the construction of these reports, one of the simpler forms issued by Bradstreet's is given below:

LACOMB, F. A. DRY GOODS MODEVILLE, PA.
Francis A., age 67, married. Clearfield Co.
March 21, 1913, he dictated to our traveling reporter the following statement, which he signed:

"Financial condition March 21, 1913, as per estimate:

ASSETS:	
Merchandise at cost	$ 50,000
Accounts receivable, actual value	7,000
Cash in bank	1,000
Cash on hand	400
Fixtures, actual value	5,000
Homestead and other real estate	80,000
Other assets, securities	1,000
TOTAL VALUE OF ASSETS	$144,400
LIABILITIES:	
On open account for merchandise	$ 6,000
Mortgage on homestead and other real estate	50,000
TOTAL AMOUNT OF INDEBTEDNESS	$ 56,000

Insurance on merchandise, $35,000. Buildings are all insured. Never suffered a fire loss. The real estate given in this statement stands of record in the name of Francis A. Lacomb.

(*Signed*) F. A. LACOMB."

He was formerly engaged as an oil producer and formed a partnership with his son-in-law, C. A. Brown, and they started in the dry-goods business in September, 1906, the firm operating under style of C. A. Brown & Co. They continued until May 8, 1907, when the business was incorporated under style of the C. A. Brown Co.

The latter corporation was organized under Pennsylvania laws, with an authorized capital of $150,000, charter dated April 18, 1907, and at the time they claimed to have a paid-up capital of $100,000.

The corporation operated two stores, one in Modeville and one in Frankdale, Pa. In a statement submitted as of April 23, 1909, the corporation represented its total assets at $162,807, with liabilities, exclusive of capital stock, of $62,807. Under Brown's management, the business is reported to have run steadily behind and to have lost money.

About January 1, 1910, F. A. Lacomb took over the business from the corporation, disposed of the stock in the Frankdale store and has since continued to conduct the Modeville store only. As one of the conditions connected with the transfer of the business to him, Mr. Lacomb is said to have assumed the obligations of the corporation. In order to provide for this indebtedness, authorities advise us that he has arranged with a local and out-of-town bank to furnish funds to the extent of about $45,000 and as security he has given a mortgage on his real estate for $50,000, as indicated by the Crawford County records of March 9, 1910, mortgage payable six months after date.

We are advised that Mr. Lacomb has been steadily reducing the C. A. Brown Co.'s liabilities, until at the present time it is understood these debts amount to about $18,000. An authority who is familiar with his affairs estimates his farm, containing about 685 acres, at about $55,000, and his real estate in Modeville at $15,000, making the total estimated value of the real estate $70,000. Other informants who have known Mr. Lacomb for many years state that he is a man of integrity, and they have expressed their confidence in his ability to put the business on a prosperous basis. The general opinion among those consulted is that his net worth may be conservatively estimated as between $35,000 and $50,000 after making all reasonable allowances.

Trade Opinions: May, 1913. In an out-of-town market two authorities have been found who have credited the concern up to $1,000 each on seventy days, and payments have been prompt. A third house has credited as high as $2,000 and payments have been lately prompt, but previously slow. A fourth authority has credited to the extent of $500, last transaction two weeks ago, and pay-

ments, at one time 30 days slow, have improved to prompt or only a few days slow. Three other dealers have credited in amounts of $75, $400, and $1,200 respectively, on 60 days, and payments to all have been prompt, nothing owing which is past due. At four other sources the account has been checked for $300 at one source, $700 at another, $1,000 at a third, and $1,500 at a fourth, and payments have been made either according to terms or fairly promptly.

.....R C.....May 5, 1913.

Of course, there are reports of much more elaborate and extended character on large wholesale houses, bankers, manufacturers, and industrial combinations, which contain exhaustive, analytical statements furnished by the concerns themselves, with appropriate comments on their prospects, degree of prosperity, character, and methods of management, and observance of their obligations, the whole forming a general summary of all the facts constituting their standing in the mercantile world.

Necessity for Cooperation

The reader has doubtless met credit men who have professed to see little good in mercantile agencies and their reports, while others, and these usually the most successful, say they would not know how to get along without them. Here we touch upon a very important point, because the results the credit man derives from agency service are largely dependent upon his attitude toward the agencies. If he recognizes that the agency is in reality but a branch of the credit department, and the workers therein but his colleagues, and gives them the keenest cooperation, confidence, patience, and good fellowship, the results to him will be rarely disappointing and the highest mutual success will generally be attained. Now, this is invariably the attitude of the credit man who says he could not get along without the agency. The largest firms and most successful houses with which I am familiar are liberal

users of agency service and reports, never curtailing their credit men in this respect. They regard the disbursement for agency service as nominal when they consider the volume of credit business they transact each year, and which the agency service aids them to protect. They realize that they cannot have at hand too much information on the people to whom they are selling; they see the importance of being entirely familiar with the business of their customers and the various conditions surrounding them; they understand that it is not only a question of extending or not extending credit, but also one of how much.

Accuracy of Information

The credit man's constant cooperation with the agency is of very great importance. If every credit man were to educate the salesman to state on the order blank in every case the proper official style of the firm on which information is desired, correctly spelt, instead of some nominal trade or awning style which may have been used by different owners of the business for as much as ten years past, this one improvement alone would vastly increase the promptness of agency service; as much wasted time and effort would then be avoided, which could be used to advantage elsewhere on the subscriber's behalf.

Of equal importance is the street address of the customer in the larger towns, which salesmen should always be required to furnish. Lack of proper firm name and street address on the inquiry blank which the agency sends to its correspondents, especially in the larger towns, causes more good correspondents to resign their posts than any other known cause. The character of agency work requires a responsible, intelligent, representative man; and the services of such a man cannot be retained if he receives many inquiries which, in consequence of a defect in the

firm style or street address (the last particular is sometimes entirely missing), make it necessary for him to go through the town with a fine tooth comb in order to locate the subject of inquiry. He cannot afford to waste his time this way, and soon resigns. This is a considerable detriment not only to the agency itself, but to the subscriber, as good correspondents are not so plentiful and so readily engaged as might be supposed.

Completeness of Information

Moreover, if every credit man would fill in as far as possible answers to all the questions on the back of the inquiry ticket, it would further the efforts of the agency to supply quick as well as accurate service. It is absolutely essential that the agency and the credit man work together if prompt service is to follow, and yet I have known some instances where subscribers have withheld information when putting in an inquiry, which, if given to the agency at first as a clue or lead, would have saved much valuable time. However, it is only fair to state that most modern credit men are trying to help the agency and incidentally themselves in every way, though many of them lament the difficulty of educating the sales force to the importance of the details mentioned.

Insufficiency of Private Investigation

The reason why each credit department does not, as you might say, act as its own mercantile agency, is because it lacks the necessary facilities. Hence, the mercantile agency steps in and acts as agent for all dispensers of credit the country over, devoting all of its time and energy to this one feature of modern business. With its vast organization over the whole world, its many offices, its rec-

ords, and its experience, it is able to gather and issue to its subscribers dependable reports at a nominal fee compared with what it would cost each credit department to secure these data itself. As a matter of fact, there are probably some portions of the antecedent record of the subject which neither the credit department nor any affiliated credit bureaus could possibly secure.

As an illustration, let us say that John Smith is a newcomer to a community; commences business forthwith, and says he came from some little hamlet in Alaska, or Honolulu, or Australia, or any other remote point on the globe. Could the credit department obtain this man's antecedent record? No; but the office of the agency reporting the previous place of residence of John Smith will have on file his business history, which will reflect his reputation, his manner of paying bills, court records covering such things as judgments for debts and petitions in bankruptcy, if any, and finally his reported financial worth at time of leaving.

Importance of Antecedent Record

This antecedent record is often more important than any other feature of the report, especially if it indicates traces of dishonesty, for it may be presumed that a man's antecedents will exercise some influence on his future record. The mercantile agency records bear this out. It is nearly always the case that the merchant who has been in business for a term of years and has maintained an honorable position as to his dealings and the discharge of his obligations (this, by the way, does not necessarily imply invariable promptness), sustains this favorable record to the end of the chapter, no matter where he may go. It is always safe to extend reasonable credit to a man of this kind almost regardless of his capital, because he will be a

careful buyer, not likely to contract beyond his ability to pay, and will in all probability eventually bring his newest business to a successful issue, as in the past. The exceptions to this general rule are so rare that they simply help to prove it. And if a man with a good record wanders from the straight and narrow path and causes a money loss to his creditor's firm, the credit man is in no measure to blame, nor is the mercantile agency, for neither can look down into a man's heart and foretell what he is going to do. If he has previously been recognized as a reputable man, we are justified in assuming that he will continue to deal honorably; and the agency records show that in the very large majority of cases this judgment will be correct. This works both ways, however; so it is well to remember that usually, where antecedent investigation shows a man's record to have been bad in matter of principle, he should be closely watched, and transactions with him well guarded, for this kind of man will generally repeat his previous record. It will be seen from this how important a factor is the antecedent information embraced in mercantile agency reports. Indeed, many credit men, to save time, endeavor to learn from the customer starting a new business, where he was formerly located, and convey this information to the agency when putting in their inquiry. This enables the agency to start a request for the man's antecedent record by first mail, in the meantime proceeding in the usual way to interview the man and secure his financial statement.

Accuracy of Agency Reports

It may be said at this point that failure statistics give encouraging corroboration of the substantial accuracy of the agency reports. For instance, the following statistics prepared by Bradstreet's show that there were some 14,-

047 failures during 1911 in the United States and Canada, and of this number 13,187 (or 93 per cent) had very nominal or no credit ratings; only 766 of those who failed were rated in good credit, and only 94 in very good or highest credit.

It has also been deduced from the same statistics that almost 80 per cent of failures can be traced to the shortcomings of the merchant himself. The most frequent cause of failure is lack of capital—in other words, lack of judgment shown in commencing business without sufficient backing; and next in line is incompetence, which includes poor judgment in buying merchandise or in extending credit, or in operating expenses, in pricing goods, figuring costs, etc. Inexperience and extravagance, both business and personal, also produce failures. All these main points the modern credit man has so well in mind that they almost automatically come up for consideration when determining credit or investigating an account.

The Agency Cannot be Infallible

It is the constant effort of the old-established agencies to provide the credit man with the most thorough and reliable reports humanly possible to secure. I say humanly possible because the agencies are not infallible, nor can they ever attain absolute perfection in their reports or ratings, for they have to depend upon human effort—that is, the efforts of their thousands of correspondents in the towns and villages throughout the land. The most the credit man can demand of the agency is unquestionable good faith, and a system carefully calculated to bring the service up to as high a standard of efficiency as possible. If the agency reports were infallible, there would be no need of credit men, for then the agency could automatically take their places. But since the reports are not and

cannot be absolutely free from faults, they should be taken together with other facts of which the subscriber or credit man may have personal knowledge.

Rates of the Agencies

During recent years the credit man has been asking more and more of the agencies; and willing response has been made to these demands, at least to such as were feasible. But these demands on the part of the credit man call for something in return on his part; namely, co-operation, as already explained, and in addition, a readiness to pay a proper fee for the service. The agency report of today bears but scant resemblance to the report of a decade or more ago, and is vastly more costly to procure; but the advance in the agency rates have been very inconsiderable. Personally, the writer feels that agency rates have always been too low. A disbursement of a hundred dollars or so a year for credit information by a firm which transacts annually a credit business ranging all the way from $100,000 up to several millions, is surely not exorbitant. Very often the subscription price for a dozen years may be involved in any one account or bill, and yet the service covers the credit accounts for the entire year. It would be well if subscribers could have a more direct and extensive knowledge of the difficulties the agencies daily meet with, in gathering their data. They would then be a little more indulgent and cooperative.

CHAPTER VI

CREDITS AND COLLECTIONS

By C. A. Parmelee

The Development of Business Science

Most of the risks or hazards of commerce have been gradually eliminated, and modern insurance methods have made it possible to protect the merchant on sea and land. Improved means of transportation and quick communication have resulted in greater stability of prices; but, until within the past twenty years, business has never been reduced to a science, and the greatest advancement has been made within the last decade.

A few years ago, the majority of merchants were still working in a more or less haphazard manner. They bought as best they could, sold in like manner, established a profit rate they thought necessary or that competition would warrant, and did the best they could with expenses. Having done this, they trusted to luck and waited until the end of the year for the inventory to show what had been accomplished.

But under present methods of systematizing, accounting, and the segregation of various items of profit and expense, it has become possible for the merchant to know absolutely, monthly, weekly, or even daily, his exact financial condition—how much he has made or lost in each department. Almost automatically a way is opened to remedy a weakness, stop a leak or increase a net profit.

Importance of the Credit Department

Credit is one of the principal links in the great chain upon which modern business hangs, and the most important and final accomplishment of the credit department is collecting the money. Credits and collections are just as important to a successful business as buying and selling. The tens of thousands of great fortunes that have been built up by commerce and trade had their origin, in almost every case, in a business conducted on a credit basis.

There are, of course, a few very marked exceptions; but they are almost entirely among retailers, such as the Woolworth Syndicate and many of our department stores, which are operated on a strictly cash basis in selling, but buy on credit, usually taking advantage of all cash discounts.

Credit Risks

The conduct of a mercantile business on a credit basis is not, or at least need not be, a hazardous undertaking. There will always be some loss from bad accounts in any credit business, large or small, but given proper organization and management, the rate of loss will be a mere fraction of a per cent. And furthermore, the probable loss can be forecast almost as accurately as the death rate can be figured from the actuary tables of our life insurance companies—and that is so accurate as to warrant the investment of hundreds of millions of dollars. The rate of loss from bad accounts can be so closely estimated that there are credit insurance companies which, for a comparatively small premium, will guarantee against any loss in excess of the normal rate. In speaking of the normal rate of loss I refer to the average rate which, as time and experience have shown, exists in various lines.

Duties of the Credit Man

Right here, however, is where the fine work of the credit man comes in. He must work with the sales department, to build up sales and develop trade, and must not drive it away by drastic collection methods or undue caution; and yet he must be so able and so well informed that he will not lose an account or let it run so long that it becomes unprofitable. It is easy to reduce the losses if you ignore the necessity for business development.

It is the duty of the credit department to act as a guardian over the many customers throughout the country. They should not be permitted to overbuy, and so contract obligations beyond their financial strength. If credit is easily obtained, and they do not feel the serious obligation of paying accounts when due, there is, in nearly all cases, a tendency to overbuy and thus accumulate dead stock, and this results in loss of profits, a generally unsatisfactory condition of business, and too often in final failure.

The credit man should also insist that the stock of merchandise of all debtors be adequately insured. This is a necessary protection for all parties; and a business that cannot afford to pay the premium on a fire insurance policy should not be allowed to continue.

The custom of charging interest on overdue accounts is becoming quite general, is entirely just and to be encouraged.

Duties of the Collection Department

The art of collecting can be successfully practiced only by those who have patience, good judgment, courage, and decision to act quickly in emergencies, and a willingness to use harsh methods when conditions demand it.

It is the first duty of the collection department to col-

lect accounts when due. It will be found that a fairly large percentage of debtors pay promptly and therefore require little attention; the remainder come under the various headings of slow, very slow, undesirable, and bad, and must be watched.

All accounts should be watched at all times, but especially the slow accounts. When the reason for slow payment is discovered, the remedy can usually be found. It is very necessary to keep in close touch with debtors; and a personal visit of the credit man to the debtor, as often as once a year, is very desirable. This gives an opportunity to size up not only the man, but also his business, his methods, and the condition of his stock. Then again, a man is sometimes A-1 this year, but by next year is on the down grade, and the account may, in a short time, change from good to bad.

Watching an Account

I recall an instance of a jeweler in one of our nearby cities, who had been an excellent customer for a number of years. He did a good business, and his account was very desirable. After a while, however, we noticed that he was getting a little behind. When he was reminded of his past-due account he replied giving a very plausible excuse, and asked for a considerable extension on most of the indebtedness. Owing to his previous record this was granted. A few months later he did not reply to correspondence, and investigation disclosed that he was drinking to excess, and gambling; but all this had been carried on so quietly that our regular salesman had not learned the facts. I then made a personal call, and spent the entire day with this man getting information. Conditions were so bad that his continued patronage was not wanted, and I was free to use harsh methods so far as necessary.

As a result, $500 was raised that day, some merchandise was returned, and a fairly satisfactory adjustment effected. Within 60 days he was forced to make an assignment, with assets of $2,500 and liabilities of $6,000. This is an example of how quickly a good account can, under adverse circumstances, become a bad one.

It is equally important to watch weak or even bad accounts, for in this day of speculation and quick profits many a poor risk has suddenly become a desirable and profitable account. I have in mind a man in this city who today is worth undoubtedly $20,000,000, whom our firm only a few years ago, and for good reasons, held strictly to C. O. D. He was broad-minded enough, however, not to hold a grudge, and when he had money became a liberal buyer, running an account.

System in the Collection Department

On the subject of system in the collection department, I cannot do better than quote the following article*:

"PLAN YOUR WORK—THEN WORK YOUR PLAN."

"The best results in collection come from working on a systematic plan, which begins with a request for payment when an account becomes due and ends only when the money is collected, hammering away at regular intervals with form letters when they can be used effectively, but discriminating carefully in their use, and changing the forms frequently.

"Work on collections begins with the monthly statements. All statements should be out not later than the 5th of each month; and, if it is possible, have them out on

*By R. W. Van Valkenburgh, of the Western Electric Company of New York.

the 3rd. When you get statements from the bookkeeper divide them into three classes:

1st. Those having items dated only during the previous month.
2nd. Those having items dated in the second previous month.
3rd. Those having items in the third previous month or prior.

"The first class may go without comment, as they are not due and will not be due this month. The second class should be copied, name, address, and amount, then sent out marked: 'Please remit.' The copy will be kept until the 20th, when you will write a form letter to those who have not paid. The third class you will associate with correspondence, either writing a letter to be sent with the statement, or noting the amount on correspondence and sending statement out without comment. During the last few days in the month, it is a good plan to write to nearly all of your overdue accounts; then when the statement comes through you can rush it out without a letter, and it will act on the customer as a reminder of the letter received a few days before.

"Do not get into the habit of just asking for money—call attention to indebtedness, first in a form letter, after that write such a letter as will appeal to the man you are writing to. In order to do this you must know your man. There is a considerable percentage of your customers to whom form letters should not be sent, and there is some question of their value after the first letter. I prefer to study each account, and write the letter that I think will bring the best result from the particular customer in hand, using model letters instead of form letters. By model letters, I mean letters that have been well thought out,

and from which I can extract a well-turned phrase to meet the case in hand. Certainly it is a mistake to let a customer know you are writing him form letters.

"The second letter I have usually made to express my disappointment or surprise at not having received the remittance asked for in the previous letter, taking at all times the stand, in a firm, courteous manner, that, as the amount is due, I am entitled to a remittance or an explanation.

"The third letter might call attention to the previous two, and notify that draft is being made through the bank with whom the customer does business. To provide this information, names of banks used by customers should be taken from incoming remittances and noted on the ledger.

"It is not worth while to apologize to your customers when you want them to pay up—for instance, asking them to pay because 'we are in need of funds,' or 'have large obligations to meet.' You really want them to pay because the money is due; and if for any good reason they cannot pay, you should usually be willing to extend more time; but you are entitled to a reason; and most men will think more of you for saying what must be said in a straightforward business-like way, appealing, whenever possible, through your personal knowledge of them. In this connection let me say that it is just about as important for the credit man to know the customer personally, as it is for the salesman to know him. There are a good many customers in every territory whose accounts will be made larger when the credit man can see and talk with them.

"Insist that the books be kept posted up to date. You cannot pass credits nor make collections intelligently unless you know how your accounts stand. If you cannot get action from other employees, go to your manager without

hesitation and without delay; a man responsible for credits cannot afford to take chances on some one else's poor work.

"Keep after the claim department all the time in the effort to keep accounts clean.

"Labor diligently to gain the confidence of salesmen, but do not stand for any sales work that interferes with collecting on regular terms, except with the knowledge of the manager. If anyone gets better than regular terms you must be consulted, and it is your duty to pass on them. Do not allow salesmen to make note settlements without consulting you. Advise freely and often with the salesmen regarding their customers, and be liberal in extending credit, but make the distinction between liberality and recklessness; and when a customer whose account amounts to $500 or more, ignores your correspondence, or you have reason to believe he is in trouble, it is time for you to get out and see him. You will at least impress him with the feeling that you not only want, but expect, fair treatment, and you consider it only fair that he answer your letters. At the same time, if a credit man approaches the average country merchant in the right spirit, he can do a lot toward cementing the customer's friendship to the house.

"You should rarely lose a large account, because you should be watching them so closely and know them so well, that if there is danger you are the first to know it and therefore first on the ground. 'First come, first served.' Do not force anyone except as a last resort; and on an account of any considerable size, see the man before giving it to an attorney. You can almost always effect some kind of a settlement by getting in personal touch with the customer, and you do not antagonize him as you do when an attorney is called in. Try to look at

each problem as it comes up, in a big, broad-minded way. Be liberal, honest, and fair; make that your attitude, and you cannot help but be right a good part of the time."

Legal Methods of Collection

The credit man should have a fair amount of legal knowledge, so as not to be entirely dependent upon the services of an attorney. Such knowledge, and judgment as to just how and when to act, has saved many an account, especially in cases of attempted fraud.

It is often advisable to bring suit and get judgment even though there is, for the moment, no chance of making collection. If the debtor has nothing and is unable to pay, get a note if you can do no better. If this is refused, and the debtor is not an old man, it will usually pay to bring suit and get judgment. The judgment can easily be kept alive for an indefinite number of years, and it is very probable that sooner or later the debtor will acquire property, and the account can be collected. The law allows interest on judgments until paid.

I recall an instance in which an account of this kind was assigned to the local board of trade. They secured judgment and kept it alive; and many years after we had written the account off to profit and loss, and forgotten it, they found the debtor possessed of real estate and collected the entire amount with interest. On another occasion a hotel man deliberately planned to beat us out of his account by transferring his property to another person. Later on, one of our collectors chanced to overhear a remark, made by him in a public place, to the effect that he had a certain sum of money on deposit in one of the city banks. We acted upon this information, brought suit, and attached his bank account; but through some technicality he kept the money from us. We nevertheless se-

cured a judgment, which we kept alive for years; and finally he found it so difficult operating in his wife's name, that he voluntarily came forward and paid up.

Another debtor, in order to swindle his creditors, placed his property, worth about $25,000, in his wife's name. We with others brought suit, got judgment, and quietly waited. Later on, the man and his wife separated; and the husband brought suit against his wife for the property, stating in court that it was his. This, of course, was our opportunity.

Collecting by Instalments

Excellent results are often obtained on slow or even bad accounts, by arranging for small and frequent payments. Many a debtor cannot get together $50 or $100 at a time, but can raise a smaller amount, and by getting this down to a weekly basis, great progress can be made in a few months.

Often a debtor will consider a note more binding than an open account, or will make more effort to meet it when due.

The following form of instalment note is legal, and leaves the account in such shape that any default of a small payment makes the entire amount due and payable:

$1096.03

Los Angeles, Cal., Jan. 27, 1913.

For value received, we promise to pay to the order of Blank Company the sum of One Thousand Ninety-Six and 03/100 Dollars, payable in instalments as follows:

On February 5th, 1913	$ 366.03
" March 5th, 1913	365.00
" April 5th, 1913	365.00
Total	$1096.03

Each instalment to bear interest at the rate of six per cent (6%) per annum from date hereof until paid. Should default be made in the payment of any one of the said instalments, or of any part thereof, or of the interest thereon, upon the day whereupon the same becomes due, then, and in any one of the aforesaid contingencies, the whole of the aforesaid principal sum, or any balance unpaid thereof, together with interest thereon, shall immediately become due and payable. The note shall be payable at the Bank of ————————, San Francisco, California.

Troublesome Retail Accounts

In the retail business there are many excellent accounts with rich patrons, which are very difficult to handle. It is not uncommon for a very wealthy woman to make frequent and large purchases, and expect the account to run indefinitely, sometimes for months or a year. If an attempt is made to hurry the collection, it is resented, and the account taken elsewhere. This state of affairs is exceedingly unfortunate, and the merchants who have allowed such conditions to grow and thrive are decidedly to blame. The conditions are, however, very difficult to correct, as no united action can be secured among retailers because of their fear of losing good customers.

The Wealthy Customer

I recall an instance of a millionaire customer, who had traded with us for years. She had been allowing her account to run until it was hardly profitable to carry it. The credit department then commenced to write collection letters, which at first had no effect; but after sending the second or third, a check in full payment was received, together with a very indignant letter. Our customer declared that she had traded with the house for over twenty years, but that if this was to be our attitude she wanted the account closed, as she had no time to check up and

attend to these bills, and would not trade with a house that was not willing to allow her to pay at her pleasure.

The usual conciliatory letter that is necessary under such circumstances was sent her in reply. An occasion like this always gives a good opportunity for a rather lengthy letter going into details, which can often, without giving offense, make quite clear the position in which the firm is placed, while at the same time it shows a willingness to co-operate with the customer so as to make the continued carrying of an open account mutually agreeable.

In the instance referred to, the lady continued to be a regular customer. I have noticed that her account has never since run over 30 or 60 days, although several years have now elapsed. I maintain that all accounts not paid within a reasonable time should have personal attention, no matter how rich or influential the person may be, and this rule generally works out right.

Liability of Stockholders

In the case of a corporation becoming involved, and unable to pay its debts, the stockholders in some few states become personally responsible, in proportion to their holdings; and in these states it is possible to collect either in part or in full from the individuals, though the corporation is insolvent. Even in these states great care should be taken in selling to a corporation that is still in process of organization, as a stockholder is only responsible for debts incurred after he has acquired his stock, even though he may be an owner at time of delivery of merchandise, and derive the benefit from same.

There was an occurrence of this kind a few years ago, when a large hotel corporation was being projected. The proposed stockholders had agreed to organize as soon as certain legal details were completed; a manager was

engaged; much of the money had been paid in; and the building was in course of construction. In order to obtain in time, certain supplies which had to be manufactured in the East, orders were placed by the manager in October, delivery to be made in January. The organization was not completed nor stock issued until December. All the forms, however, had been regularly complied with before arrival or delivery of the merchandise. In April, the corporation, through bad management, went into the hands of a receiver, and there was nothing left—after the building material men were taken care of—for unsecured creditors.

Suit was brought by the Eastern firm against the stockholders, on their personal liability as stockholders. After a long, tedious time in court, the case was decided against the firm, for the reason that the stockholders had not acquired their stock at the time the order was placed, although they were bona fide stockholders when merchandise was delivered, and had accepted and used the same, and refused to relinquish title to the property.

Staving Off Disaster

Occasionally a good business man, with good opportunities, will become involved; and through misfortune, or some cause for which he is not responsible, will be unable to meet his obligations. Then, unless he is helped financially, and an extension granted, he faces sure ruin. In such cases a general meeting of creditors should be called, so as to prevent any one firm taking undue advantage. By this means a firm is often saved from ruin, and in a reasonable time is again on a profitable basis.

Local boards of trade have done much good along these lines. They have also assisted in making satisfac-

tory adjustments, and in the selling and handling of stocks of goods for the benefit of both debtor and creditor.

Conditional Sales

In many lines of merchandise it is possible to handle accounts in a way that is practically free from danger of loss, by selling on a lease, or conditional sale contract, whereby the title of the property does not pass to the purchaser until entirely paid for. This plan is being followed very extensively on all classes of merchandise except perishable goods, or such as are consumed in use, like groceries. The form of contract used is very simple; and it is not necessary that it should be recorded. Failure to pay as agreed is sufficient cause for removal of goods. If, however, a fairly large payment has been made in advance, the purchaser is sure to pay the balance if possible, when due. Merchandise held under such contract cannot be sold by the purchaser or removed, nor is it subject to attachment.

Cooperation Among Credit Men

Friendly relations should be encouraged between the credit departments of competing firms, for mutual assistance and the exchange of information on slow or doubtful accounts. The services of the commercial agencies also are always necessary and valuable.

Collection Agencies

Many collection agencies exist throughout the United States, a few of which are good, and sometimes able to collect bad accounts which have been given up by the firms holding them. Great care should be exercised in employing such agencies, however, as far too many are irrespon-

sible and do not turn in the money collected. It is my opinion that a properly organized collection department can do about as good work on bad accounts as any outside firm, although such accounts are disagreeable, and require a great deal of labor and time.

But a collector will not be a success unless he thrives on work, and is willing to patiently labor, day after day, until he can bring results.

Successful Strategy

Strategy, new methods, and timely schemes, are necessary to bring results on many of the accounts that have become habitually slow.

On one occasion a dealer in Santa Barbara had persistently maneuvered to avoid paying a $300 account that was over a year old. He had a fair standing, and we hesitated to bring suit, yet could not afford to sell him any more goods without a settlement. Knowing that he would take in considerable money during December, we wrote him that we had divided his account into ten distinct parts, making a draft for each amount, and dating the drafts in such a way that one would be presented each day, beginning with the 15th of December. The amounts were small in the earlier drafts, and made larger as they came nearer to December 25th. We arranged with the Bank at Santa Barbara to wire us in case any draft was not paid promptly, and also engaged an attorney, telling him to be ready to file suit in case we notified him. All the details of the arrangements were explained to the debtor, and he knew that if he failed to pay as arranged, his place would be attached during his holiday business. The scheme worked well and the entire account was paid. Strange to say, he took no offense and has since given us business, but on a cash basis.

Hard Work

The way of the collector is always hard. There is no quick and easy way to collect all accounts, but persistent work will count; and the heart of the collector will frequently be cheered by some unexpected pleasure, such as the payment of an old or outlawed debt.

CHAPTER VII

AUDITS AND INVESTIGATIONS

By W. C. Mushet, C. P. A.

In taking up the subject of accounting in relation to credits, I wish to speak of credit in a rather comprehensive way, and there is one central thought that I wish particularly to emphasize, and that is the importance and necessity of strict investigation in all matters relating to credits. In this investigation accountancy will frequently play an important part.

Sources of Information

Now, with regard to merchandising. What is it that a merchant wishes to know about accounting in relation to credits? He wants to know the financial standing of his customer. But he does not want to stop there; he also wants to know the history of his customer's business, and where can he get that information?

Well, he goes to Bradstreet, and he goes to Dun, asking for the commercial standing of this or that man; and he gets a report which purports to tell him what that man's assets are, and what his liabilities are, and what is his net worth. But where do Bradstreet and Dun get their information? First, they go to the prospective customer and ask him for a statement. They ask him to tell them about himself.

Mr. Isaacstein's Mistake

I remember a story here that illustrates the point I want to make. One day, early in March, a man with a handful of papers went into a store on Main Street—I don't know whose store, but we will say it was Mr. Isaacstein's—and he said, taking out his papers, "I would like to find out how much stock you have got." Mr. Isaacstein suddenly became very busy—so busy he could not stop to make a calculation—but volunteered in a very large way, "Well, we have got about $10,000 worth of stock on the shelves." "Yes. And how many solvent creditors have you got? How much is owing to you that you consider good?" "About $5,000." "Well, how much do you owe?" "Don't owe anything." "Good," said the inquirer. "I'll see you later." So that afternoon he returned to the store, and taking out his papers, announced, "I have come to collect your personal property tax." "Well," said Mr. Isaacstein, not remembering him, "I suppose you want to find out what property I have got." "Why, no," explained his caller; "I was here this morning, and you told me." And he assessed him accordingly. Mr. Isaacstein was angry, and said, "My friend, you did not treat me right. I thought that you were a Dun or Bradstreet man!"

Credit Misinformation

You will note that it is not a legal crime to lie to Dun or Bradstreet. If it were, there would be no necessity for the act now before the California State Legislature to make it a crime for a man to make a false statement in writing to either of these agencies.

Dun and Bradstreet do not rely entirely on the statement of the party himself, but make every effort to get

corroborative evidence. They go to the creditors of the man that they are investigating, and also to the bankers, but they do not always get the truth even from those people. I remember the case of a man in Arizona who was on the verge of failure and owed the bank in his town some six or seven thousand dollars. He wanted to transfer his account from that bank to one of the very large banks in a distant city, and the two bankers had some correspondence on the subject. The local banker, knowing the true conditions, and wishing to "get from under," gave the debtor a very excellent reputation, and the account was removed from Arizona to the distant city, to which news of the depositor's failure came some few weeks later. It is evident from this that sometimes even a banker, in order to save himself, will give an incorrect statement regarding a debtor.

Board of Trade Reports

Of course the agencies do the best they can. They get the information; but the information that they get necessarily must come chiefly from the debtor and from the references that he gives.

For the betterment of this condition the Los Angeles Board of Trade maintains a reporting bureau, which gets a great deal of advantageous information for the credit man. Similar bureaus are maintained in many other cities. The plan works something like this: Mr. Jones of Los Angeles has applied to you for credit. You want to know how he stands, and you send an inquiry to the board of trade. The board of trade will list all such persons inquired about, and that list will be circulated through the trade, and the next day the information received will be tabulated. In this way the board finds out each day, or as often as called upon, how much a certain

man owes at a certain time, and how much is past due; and also gets information as to the character of the payments. But this report, you see, deals only with the liabilities of the man. Next, they send out a request to the party for a statement; that is, they send him a form asking him to make his own statement about his affairs.

Scope of Statement

Now, all these things deal with the present condition of the debtor's account. But that is not sufficient. It is necessary to know how that man stands today, but you want more than that. You want a history of his business. You want a certified statement from his books and records.

But what are you going to do when there are no books? Unfortunately, many a small merchant does not keep books in any real sense. You will find in his store a couple of spindles, on one of which he puts the bills as they come in, while on the other he puts the bills as he pays them. He may also have a blotter in which he records the sales he makes on credit. Sometimes you will find both a blotter and a cash record, but there will still be absolutely no record of his investment. What is to be done under such conditions?

Proper Records

Of course, we have the remedy for this condition in our own hands. In England, it is a statutory offense for a retailer not to keep a set of books; and a like condition can be brought about in this country. But at present, in a case where there are no books, all that you can do is to investigate the past history of the concern, and insist that in the future some fundamental records shall be kept. You already require your customers to carry fire insurance.

Insist on their keeping proper records, just as you insist on their carrying fire insurance. Require them to keep simple records of account, not only for your benefit, but for the benefit of the owner of the business himself.

Incomplete Statements

But suppose that a proper set of books is kept, what is necessary? You want a certified statement from those books and records, and you want the whole truth. Not a part of the truth, but the whole truth. I remember an instance in point. A certain concern in my town was in difficulties; and a statement signed by a certified accountant was placed upon my desk, showing that the assets were $123,000 and the liabilities were $100,000. That looked as if there were a surplus of $23,000. The business had been running for only ten months, and it appeared that it had made $23,000 profit in that short period. But when I made a personal investigation, this is about what I found. The assets on the ledger were apparently $123,000, and the liabilities were $100,000. The expenses stood at about $60,000, making the gross gain $83,000. Yet this company, instead of making a profit of $23,000, had actually made a loss of $27,000. But, as it would not help the sale of its stock to go before the purchasing public with a statement showing a $27,000 loss in operating in ten months, the officers of the company asked an accountant to tell them what they should do. The accountant went home that night, after inspecting the books, and dreamed that some timber lands owned by the company up in Oregon had increased in value from $50,000 to $100,000. Accordingly, he put a profit of $50,000 on one side of the ledger, to balance the loss of $27,000 which appeared on the other side, and the result of this was an apparent net profit of $23,000. A number of indictments followed this

discovery, and two of the manipulators of that fraudulent corporation are now serving time.

Yet the books were technically correct, and the bookkeeper, a German, kept them magnificently, with faultless neatness and accuracy. But he was a mechanical bookkeeper. After he had written the books up, he did not understand what they spelt, and the poor fellow invested $7,000 of his own money in that fraudulent concern, and lost it, simply because he could not read the handwriting on the wall, though he had written it with his own hand.

Profit and Loss Statements

I repeat to you, therefore: When you get a statement, get a statement of the *whole* truth. It is very easy to cover a multitude of sins by saying: Assets, $123,000; Liabilities, $100,000; Surplus, $23,000; but that is only half the truth. This is an asset and liability statement—a capital statement—and it does not say a word about profit and loss. You can take up any newspaper, you can take up any report of any institution in America, and all you get is a statement of assets and liabilities; that is, just one-half of the truth. But, if you had *all* the debits and *all* the credits —a capital statement and also a profit and loss statement —then you would know what was going on. In the instance just quoted, if, instead of merely giving an asset and liability statement, and showing a surplus of $23,000, there had also been a gain and loss statement, the $50,000 in assets which had been thrown into the accounts would have been disclosed, and people would have asked where that $50,000 came from. Then they would have discovered that it was not an operating profit. There was, in fact, an operating loss of $27,000; and even admitting, for the sake of argument, that the price of that Oregon property had actually increased $50,000, that increase

was a capital increase and not an increase from operation.

There are two kinds of profit—a profit from operation, and a capital profit. And if a statement submitted shows the difference between these two kinds of profit, you will get the whole truth and not half of it.

Responsibility of the Accountant

In the case just cited, the accountant deliberately made a false report, and was as guilty as the officers of the company who were indicted for fraud. There should be some means of holding an accountant responsible under such circumstances. In England they manage things of this kind differently. The English Corporation Act requires that any company selling stock to the public shall have an auditor *appointed by the stockholders*—not by the officers and manipulators of the corporation—who makes a semi-annual examination. He then reports to the stockholders, and he must give them not only an asset and liability statement, but a gain and loss statement also.

Now, that is what we should insist upon. A merchant wants to know, not only what a customer is worth today, but how much he has made or lost in his business during a definite period of time.

A lawyer came to me some time ago for advice in regard to a client of his. This client had entered into partnership with another man a year or two before, and each of them had invested $1,800, making $3,600 altogether, which constituted the assets of the business. His client, however, had put in $1,800 of actual money, while the other partner had put in his business at an estimated net worth of $1,800; that is, he claimed the assets were worth $1,800 net, over and above the liabilities. No statement of profit and loss was shown, and in the course of the year it was found that the real value of the business had only

been $900—just half of what was stated. In other words, my friend's client had been swindled, and the original assets of the firm were only $2,700. The business was continued, but lost money right along. "We have just taken stock," said the partner who had invested the cash, "and find that the assets figure $3,000, and the liabilities $1,800, so that all we are worth is $1,200 as against $2,700 a year ago. In other words, we lost $1,500."

Now, that is what the merchant wants to know. It is true that he is interested in knowing that the assets today are $3,000, and that the liabilities are $1,800, and that there is a real investment there of $1,200. He wants to know that; but he also wants to know that during the year the investment has dropped from $2,700 to $1,200, and that there has been a loss, if such is the case. He should know that, although the principal is still alive, it is in a precarious condition, and he will never find it out from an asset and liability statement. He must have the whole truth in order to make an intelligent decision, and that is why I am insisting upon the necessity of showing the losses and the gains, as well as the assets and liabilities.

Optimism is Natural

A man making a statement of his own affairs will naturally put his best foot forward. He will even deceive himself. He is optimistic. He will inflate, in his mind, the assets, and he will deflate the liabilities. You know Bob Burdette's story about the optimist and the pessimist. "The pessimist says, 'I wonder if there is any milk in that pitcher!' And the optimist says, 'Pass the cream!' " Business men are all optimists naturally, or should be. They are going to put their best foot forward. They are going to make things look as rosy as they can, and it is for the credit men to get right down to the true facts.

Inflated Assets

Not very long since, I was going over the books of a large water company, and we put in a record of material. I had them take stock of the material, and compare it with their material account upon the ledger, and they discovered that the material by actual count was about $1,800 less than the material account upon the ledger. A few days afterward they had adjusted this difference. They did not alter the ledger account, but they fixed the material, which, from my point of view, means that there is an inflation of $1,800 in the material account.

Depreciation of Assets

In our investigations we must not only watch for inflation of values, but must also watch to see that proper allowance has been made for depreciation. Sometimes the allowance is too small, and occasionally it is too large. I once knew a gentleman in the agricultural implement business who, when he took his inventory at the end of the year, wrote off 50 per cent of any merchandise that was on hand the year before. In other words, if it had not moved during the year, he considered that half its value had gone. If it had come in during the year, depreciation was reckoned on a lower scale; but if it had been on the inventory two years before, he depreciated it 100 per cent. He simply listed it. Now, that may be a little extreme; but you will often find, when you come to scrutinize a list of assets handed you, that the person responsible has gone to the other extreme, and has made no allowance whatever for depreciation.

Accounts Receivable

Then again, some people will carry accounts receivable on the books for years and years. They don't write them

off because they look like an asset. Notes receivable are often treated in the same way. I remember such a case some years ago. There were two boards of trade in a certain city, and naturally they were antagonistic. The standing of a debtor had been submitted to one of these boards, which, after a little investigation, said to the man: "Oh, everything is all right, we will give you an extension of time; go on and attend to your business, and we will see that your creditors do not make you any trouble. Leave it to us." One of the creditors, however, brought that man into the other board of trade, with which I was connected, and we also went through his affairs, and our report was very different—so different that his creditors said: "This man's condition is so serious that, in order to protect ourselves, we must take a transfer of his assets. He is not in a fit condition to run his business, and his business is not in a fit condition to be run by him; he has lost too much money already."

Now, where did the difference come in the viewpoint of those two boards? Right in notes receivable. When we came to scrutinize the seven or eight thousand dollars of notes receivable listed as assets, we found they were notes given by an individual member of the firm to the firm. The man was listing as assets his own notes!

Understanding the Liabilities

As to liabilities, they are very apt to be understated. I could narrate to you from my own experience numbers of cases where companies have understated their liabilities. In one concern that we investigated, we had to make adjustments of the aggregate amount of $108,000, debit and credit, in order to put a true record on the books as of a certain date. And that meant that this concern, which had been paying dividends in the belief that it was solvent,

as a matter of fact, had not made any profit, but had been running at a loss and did not know it. Now, if the concern itself did not know it, how were its creditors to find it out without an investigation?

The Public Needs Protection

If a merchant needs a credit man to look after his business for him, how much more does the public need a credit man to look after its business? It is popularly supposed that the public likes to be humbugged. That may be true politically, but I do not think it is financially. It is a common saying that a sucker is born every minute. That may be true in one sense. It is also said that the best bet is the public apathy. As a matter of fact, Get-rich-quick Wallingfords in this country get millions of dollars from the unsuspecting public every year.

What we need is a law which will force all stock-selling corporations to tell the whole truth, and let us have the operation account as well as the statement of assets and liabilities. The public wants to see that profit and loss statement. It is all right to have a statement of assets and liabilities; that is good as far as it goes; but it is only one-half the truth; and if I must have but half, the half of the truth that I prefer to have before me is the profit and loss statement, which shows where the profits—if there are any—come from. When you find that out, you know where you are.

Building Associations

Now, I want to tell you about home building associations. There are many of them, and some are better than others, but they should all be investigated before you trust your money to them. Let me give you a typical statement:

Operation, one year:

Legitimate profits	$10,000
Rise in the value of real estate	70,000
Premiums on sale of stock	20,000
Total	$100,000

Now, they had made an operating loss:

Expenses	$90,000
Dividends	10,000
Total	$100,000

As you will note, the profits were made by raising the assets value. They threw the increase into the gain column. The stockholders got in on the ground floor, but the manipulators got in at the sub-basement!

An accountant came to me today and said: "The company I am investigating has been operating at a loss, but the directors have declared a dividend, and are carrying a surplus over into the next year. How can this be?" I explained to him the method: Buy a piece of property today for $100,000. Go home, go to sleep, have a dream. Tomorrow morning put it on the books at $200,000. Profits $100,000! What a fine investment! Of course, a rise in the price of stock follows; and when stock rises and the premium is paid on it, then take the premium for profit. You receive $200 for stock, par value $100, and you put the $100 on the books as a liability—a capital liability of the stock, while the premium is a profit thrown into the gain column.

Then dividends; and so on, and so on, until the crash comes, as it is bound to come sooner or later. And what then? They have been discounting future dividends. If the company is paying all the profits in dividends now, then when the stock is all sold and there are no more premiums and property ceases to rise in value, or is sold at an increased price which has already been taken into

consideration and declared as dividends, what is going to happen? First, the dividends will grow smaller; by and by the dividends will pass; and then there will be assessments. This is not a guess; it is something that is happening, not occasionally, but continually.

Necessity for Surplus

Now, when assessments come, there will be a fall in the price of that stock; and when the stock falls in price, there will be a panic among the stockholders; and when the panic comes, there will be a further fall in the price of stock; and so on. This is the penalty for such manipulation. To inflate values is unsound accounting, is unsound financiering, is unsound legally.

To illustrate the danger of such inflation, I may mention the case of a man who paid $30,000 for an orange grove in Southern California just before the severe winter which destroyed the groves in that part of the state. Three months after he purchased the grove he was begging someone to take it off his hands at $15,000. That winter meant to Southern California a loss of millions of dollars. Such calamities must be provided for; and to offset these is a good way to dispose of that rise in the value of property. And right here I want to quote a paragraph in regard to a court decision on the matter of paying dividends in anticipation of profits. This is a New York case, in which the court said: "To calculate months in advance on the result of future transactions and on such calculations to declare dividends, was to base dividends on paper profits, hoped-for profits, future profits, and not upon the surplus or net profits required by law."

The Proper Treatment of Unearned Increment

A very wealthy corporation bought considerable land a number of years ago, and has held most of it since. That

property stood on the books at a million dollars; but at a conservative estimate it has risen in value during the last ten or fifteen years to, we will say, $2,000,000. The corporation still has the property, or a great deal of it. Now, in 1909 the Federal Government passed an income tax requiring the payment of 1 per cent upon all profits over and above $5,000. The Government does better for itself now, for under the present law it takes the tax on the entire corporate profits; but in 1909 it was satisfied with less. Now, here was a company with land upon its books at a million dollars, which was worth $2,000,000, and this gave a million dollars of profits right there.

For better illustration, take a single piece of the property that the corporation bought fifteen years ago. We will say it cost $1,000, and could be sold for $2,000 in 1909, and in 1910 for $2,200. The company had made a profit there of $1,200, but how much was the Government to get out of that? Should the Government take its 1 per cent on the total profit, or only on the increase from 1909 to 1910, which was but $200?

Here it is obvious that the Government should only tax the increase after the law went into effect in 1909, when the property was already worth $2,000, until 1910, when it was worth—and was sold for—$2,200, a profit of $200. On this the Government was entitled to its 1 per cent.

After the passing of the income tax law it became necessary to put the property on the books as of the new valuation; that is, $2,000, just twice the original cost. This gain of a thousand dollars, however, was not put in the Profit and Loss account, but was put, as an offsetting liability, into a capital surplus account; and when the property was sold for $2,200, the profit of $200 was added to the $1,000 in the liability account, which, when taken out

and put with the $200 in the gain column, made a total realized profit of $1,200.

Dividends from Premiums

I will now briefly discuss the subject of premiums on the sale of stock as a profit out of which to declare dividends. Section 309 of the Civil Code of the State of California says that dividends must not be paid except from surplus profits arising from the business of the corporation. Most of the states have similar laws. If the business of the corporation is to sell its own stock and make a profit on it, then premiums can go into the gain column, but I do not think that any corporation will claim that its business is to deal in its own stock. I do know of one corporation, however, whose only business for six or seven years has been to sell its own stock; and it has declared dividends, not once but many times, absolutely without any justification. In all the years of its existence its legitimate profits have not amounted to $3,000, but it has traded notes which it took for its own stock to another concern, and has gone on accruing interest on those notes which it did not own, putting that accrued interest upon its books, calling it profits, and declaring dividends out of those profits. I attended a recent stockholders' meeting. They decided to lease a piece of property, and immediately the value of that lease was put on the books as $50,000, and dividends were declared on the strength of the profit thus disclosed. The district attorney will tell you that the improper declaration of dividends out of capital is only a misdemeanor, it is not a felony.

That company is not declaring dividends now, and a poor woman came to me, and said, "What am I to do? I haven't very much money, and I put $1,000 into this thing, not for myself, but for a niece in Philadelphia, whose hus-

band is bedridden, for it was expected to pay 10 per cent, or 12 per cent, and that would have meant $10 a month for my niece and her husband. I don't know how on earth they are going to get along without that $10." But the manipulators of that company are living in mansions that cost $100,000, and they ride in their automobiles.

I know of another case where the victim, a refined woman, has been obliged to take in washing for a living on account of these vampires. I know of a case where a dying man put all he had, $10,000, into something that he thought was good, one-half to go to his son and the other half to his daughter, and now there is nothing. I know of still another case—and all these cases have come under my personal observation—where stock is being sold at $2 par value, and the book value is only 38 cents. I knew a real estate manipulator, with his property mortgaged to the hilt—who was hard up, with not money enough to pay his taxes—who formed a stock company, and went into the business of selling its shares. He holds control of the company, and is now drawing over $10,000 a month, although its expenses are more than the income. All this money comes from suckers who buy the stock.

Getting a Credit Standing

Manipulators of this kind resort to an infinite variety of schemes to further their semi-fraudulent enterprises. A banker told me the other day of a man who came into his bank and said, "Mr. Blank, I have opened an account in your bank, and I want you to know it." "And," the banker continued, "every time that man came in afterwards with a deposit, he would make it a point to come to my desk, in order to show that he had an active account in the bank." After a while I found out what he was after, for one day he came to me and said, "Mr. Blank, there are

inquiries about us on the outside, and I should like to use your bank's name as a reference." I said, "Well, I have no objections, but wouldn't it be just as well if you told me something about yourself and your concern?" "Certainly. Do you know," he said, "that the proposition in which I am interested is going to be the biggest industry in the world?" And he explained just what it was, but the banker knew the actual facts, and told his depositor flatly that he was a gold brick artist, and a bunco steerer; and finally added, "You refer inquirers to us, and take particular care to see that the correspondence comes to me personally, and I'll tell them." But the depositor did not refer. He withdrew his account. His concern spends perhaps $15,000 a year of stockholders' money in advertising.

Swindling Schemes

Some of the schemes encountered in the course of an accountant's investigations are nothing more nor less than swindles. In one case in my own experience, the promoters of a land company wanted to get a good lot of stock for themselves without giving any real *quid pro quo*. The stock was selling at 20 cents a share. After studying over the situation, the promoters devised the following somewhat ingenious plan: They had an option on a valuable piece of land. "Now," they said, "we will sell that option to the company for $15,000; that is to say, $15,000 worth of stock." This, at 20 cents a share, mounted up to 75,000 shares. The plan was carried out. The company bought the option, and the promoters got their 75,000 shares of stock, which, in consequence of the rise in value of land held by the company, is now worth considerably more than 20 cents a share. The company never exercised the option. Of course, that was the company's

misfortune. It had paid stock actually worth $15,000 for this option which had never been exercised.

In another case which came under my observation, the swindle was even more lightly disguised. The chemical formula for sugar is $C_{12} H_{22} O_{11}$. The formula for water is $H_2 O$. Now, a very shrewd young fellow saw the formula for sugar, and it occurred to him that it looked like carbon and water. So he devised a scheme to make sugar, not out of sugar cane or beets, but out of water and carbon. Apparently he was successful. I saw him make the sugar, or thought I did, and I have some of it now. It is a very fine, pulverized sugar. The bright young man had a very elaborate mechanism which transformed the water into steam, and passed this steam through fine tubes, where it was gasified. In another mechanism he was burning charcoal to get his carbon, and these things were mixed and supposedly combined by means of an electrical current.

I do not know how he did it, but after a while the mixture came out fine powdered sugar. On the strength of that exhibit he sold a very great deal of stock. Of course, the whole thing was a humbug; and the last I heard of the bright young man the Pinkertons were looking for him.

Now, in conclusion, everything that I have said may be summed up in this one piece of advice: Always insist upon the full truth when you are asked to give credit. Get the profit and loss statement as well as the statement of assets and liabilities, and see that they tell everything they should.

CHAPTER VIII

LIENS ON PERSONAL PROPERTY*

By N. P. Conrey

Fundamental Property Rights

The Constitution of the United States guarantees to all of us the fundamental right of security for life, liberty, and property. To be a free man is necessarily to be one who is capable of holding, owning, and controlling property—things of value for personal use, of value to society, and therefore things which are articles of commerce. These things the free man may hold in his own right. To the extent of that ownership the law gives him an attribute of sovereignty. The state itself guarantees that it will not interfere with that right except where this is necessary for the public good. It is provided, therefore, that one's property shall not be taken away without due process of law; and that it shall not be taken away under any pretense, against the owner's will until after the ascertainment and payment to him of due compensation. So, a man and his property stand encircled and protected by the law.

Sale and Transfer

Now, that is good for a starting point, but no one lives to himself alone. Man is a social being. He seeks

* It is impossible to give the varying lien laws of the different states in the present volume. The California law which is discussed here will give a fair idea of the general law of liens and will indicate what the credit man must look for when investigating the matter in other states.

social relationships, or has them forced upon him. He then begins to have also legal relationships, and his property, too, begins to have legal relationships which bring him and it into touch with other members of society, and this leads to trade and transfer. Out of affection or philanthropy, you may give your property away; you may exchange it for other property or you may sell it for the medium of exchange, which we call money. There are rules of law and practice applicable to all such transfers; conveyance of land by deed or by delivery of possession; conveyance of personal property by delivery of possession and bill of sale; and so on.

Liens

Then there is another line of relationships which comes short of sale, transfer, or conveyance in the first instance; and these relationships are described by the word "lien." This word implies that the owner of the property continues to be the owner; but someone else, who is described as the holder of the lien, has acquired a claim upon that property—not a claim of ownership, but a claim of right to hold that property as a pledge, or security for the performance of an obligation which has been personally contracted towards him, or which is imposed because of some service rendered with relation to the property.

The Civil Code

In California we have a set of written laws which we call the Civil Code. We have also a Penal Code, a Code of Civil Procedure, a Political Code, and the general statutes of the state. But the Civil Code is the body of statute law in which the state sets forth especially the laws relating to property, legal contracts and obligations,

and so on. This Code is simply an expression in statutory form of the principles of the common law, modified by new declarations of the will of the state; it includes in statutory form those instances where the legislators of the state were not satisfied with the common law as it stood.

Origin of the Common Law

In your general reading you will often find a distinction made between civil and common law, and perhaps some of my readers who are not students of law will follow me more easily if I explain first what is meant by "Common Law." The states of Europe are largely controlled by systems of law derived or copied from the Corpus Juris Civilis, or Code of Civil Law of the Roman Empire—that great law-giving nation of the ancient world—and many principles of the Roman civil law have directly or indirectly found lodgment in our own system. But apart from the Roman law which prevailed in Europe, there grew up in England a characteristic English law which was not the outgrowth of centuries of learning embodied in books and formally stated by jurists, but the practical outgrowth or development of the experience of the English people and of their courts and judges. In this way they built up gradually a system of law, or rather, a congeries of laws, a hodge-podge of laws, if you please. Nevertheless, when, in the course of time, men reduced it to a more formal system, it proved to be, as Blackstone has pointed out, a beautiful system of laws, expressive of the rights, duties, and obligations of men to each other and to society. The founders of the thirteen colonies brought with them the common law of the mother country, and their descendants carried it into the West and South, so that today nearly all the

states of the Union have, for the basis of their jurisprudence, the English common law as it stood at the time of the War of Independence. When California was admitted, in 1850, the question came up as to whether we should adopt the civil law which prevailed in Mexico—to which California had formerly belonged—or the English common law. The commission appointed to study the question recommended that the common law of England, as followed in the Eastern states, should be the basis of our law. Later, when it became desirable to codify the laws of the state, the codes which I have named were formulated, among them being the Civil Code, which is expressive, in large degree, of the principles of the common law as they are found in the old records and decisions of the common law courts.

The Object of Legislation

It has been said that law is the perfection of reason. Of course, that was said by an admirer of the law; but the law, like every other human institution, has its defects. The object of the law is to promote justice by compelling men to perform their just obligations to each other and to the state; yet we frequently hear of the injustice of laws. The legislature may adopt a law that is oppressive to some one, or that fails to bring about the expected good result; and it may be that the courts, in endeavoring to apply that law as they, after study, think they understand it, may fail of perfect results as regards the administration of justice; but we have nevertheless developed in this country a system of approximate justice, a pretty good article of human justice, under which men may, except perhaps under the stress of public excitement or other unusual circumstances, live peaceably and transact business with each other.

The Law of Liens

We come now to the definition of lien as expressed in the Code. "A lien is a charge imposed upon specific property, by which it is made security for the performance of an act, and it is created either by contract of the parties, or by operation of law." In order that you may get the general meaning clearly, I have omitted a qualifying clause in that definition, which, in full, reads as follows: "A lien is a charge imposed, *in some mode other than by a transfer in trust,* upon specific property, by which it is made security for the performance of an act." Now, I think we have the idea of the lien. It is the legal right of the creditor to compel the property to answer for an obligation. As a general term the word lien applies equally to real property and to personal property.

Priority of Liens According to Date

There may be several liens upon the same thing. You have heard of a first mortgage, a second mortgage, and a third mortgage; and in the same way there may be several liens upon the same personal property, the same household goods, or the same stock of merchandise. The element of time is important in determining the order, value, or priority, of liens; and we have this rule, that (there being no reason to the contrary) liens on the same property have priority according to their dates.

Bottomry Liens

Now, there is an exception to this rule which we will dispose of in a few words, as it is of interest to a comparatively small number of business men. This exception refers to cases of bottomry and respondentia liens, respectively obtained on ships and their cargoes, where the risk is of a maritime character. Bottomry is a contract by which

a ship or its freightage is hypothecated as a security for a loan, which is to be repaid only in case the ship survives a particular risk, voyage, or period. In the case of two or more bottomry liens on the same subject, a later one would have the priority if created out of necessity. For instance, it may be that the cargo is about to go to the bottom of the sea, or its owner finds himself in some other difficulty in connection with the safety of the ship, or cargo, or with the successful result of the voyage. Now, the loan which enables the merchant to save his ship or cargo from these perils, or enables him to reach his market, will have preference over any other because of its peculiar relation to the thing taken as security, even though other liens had the priority in point of time. With the exception of these special instances, however, different liens on the same property have priority according to the time of their creation.

Distinction between the Pledge and the Mortgage

The matter of possession distinguishes two classes of liens: (1) where the owner remains in possession, and (2) where the owner goes out of possession. In the case of a pledge, the property is put in possession of the pledgee, the creditor, or a pledge holder. In the case of a mortgage, the property is retained in possession by the owner, but the creditor receives in some legal form, a paper lien—a thing of the mind, of the law. It enables him to compel payment of the debt, however, just the same as if he held the property pledged. In conditional sales or transfers of property the vendor has something more than a lien; he actually retains the legal ownership, after the possession of the property passes into the hands of the debtor-purchaser, and he may, on the failure of the purchaser to keep his contract, recover actual possession.

Formalities of a Mortgage

A mortgage can be created, renewed, or extended only by a written contract executed with the formalities required in the case of a grant of real property. That is to say, a mortgage must be acknowledged before a notary public in order to be recorded and to have all the rights that it should have. The mortgage of personal property requires further formalities, in the form of affidavits, as explained later.

The Mortgagor is the Owner

The mortgagor of property is the owner and remains in possession. He has simply made a contract imposing a lien on his property, but which does not result in any transfer of ownership except in case of foreclosure and sale. "Every transfer of an interest in property (other than in trust) made only as security for the performance of any other act, is to be deemed a mortgage, except when, in the case of personal property, it is accompanied by actual change of possession, in which case it is to be deemed a pledge." This definition again very clearly emphasizes the difference as to possession between a mortgage and a pledge.

Legal Effect of a Mortgage

A mortgage does not bind the mortgagor personally to perform the act for the performance of which it is security, unless there is an express covenant to that effect. A mortgage may be made by the owner of property as security for the payment of another man's debt. In that event, unless the mortgage specifically provides, or the mortgagor in some other way has specifically provided or made an express covenant that he will pay, he has simply handed over his property to be subject to the lien.

A power of sale may be conferred by a mortgage upon the mortgagee, or any other person, to be exercised after a breach of the obligation for which the mortgage is a security.

Assignment of Claim

The assignment of a claim secured by mortgage carries the security with it. For example, here is a note, secured by a mortgage upon land or personal property. The assignment of the note carries with it the security. The custom is, very properly, to assign the mortgage with the note, and to record the assignment. But the rule remains the same, that the mortgage is an incident to the debt, and whoever owns the debt has the right to the mortgage.

The Law of Chattel Mortgages

Now we come to mortgages on personal property. A section of the Civil Code of California, adopted in 1872, provided specifically a short list of articles of personal property on which chattel mortgages might be made, and you could not put a chattel mortgage on personal property, except as the Code provided. This list was gradually extended. The needs of business called for more liberality; and it became the regular biennial custom to amend Section 2955 of the Civil Code, describing articles of personal property that might be mortgaged. These amendments began in 1875 and extended on, about every two years, until 1907. By this time the legislators had become conscious of the absurdity of a long list of this kind, and they therefore reversed their method, and by the amendment of 1909 made the general rule that such mortgages may be placed on all kinds of personal property, with three exceptions. The amendment of 1909 reads simply: "Mortgages may be made upon all grow-

ing crops, including grapes and fruit, and upon any and all kinds of personal property, except the following: personal property not capable of manual delivery; articles of wearing apparel and personal adornment; the stock in trade of a merchant."

Executing a Chattel Mortgage

We come now to the formal steps in executing a chattel mortgage, as to acknowledgment and affidavit. A mortgage of personal property is void as against creditors of the mortgagor, and subsequent purchasers and encumbrancers of the property in good faith and for value, unless it is accompanied by the affidavit of all the parties thereto, both debtor and creditor, that it is made in good faith and without any design to hinder, delay, or defraud creditors; there must be also an acknowledgment and certificate, as in case of grants of real property. It requires two kinds of certificates—one of acknowledgment and one of oath. Now note again that there are several persons who may claim exemption; that is, who may claim not to be bound by the mortgage unless it is in this form. In the first place there are the creditors of the mortgagor; that is, any creditor other than the mortgagee, who may be seeking to find the property of this mortgagor and bind it by some process of law to compel the payment of debts. Or, suppose the man who has made or attempted to make the mortgage, has made no such affidavit, and subsequently sells the property. The mortgage would be void as to any subsequent purchaser in good faith and for value, or as to any subsequent mortgagee. Thus great care must be exercised with regard to the form of the mortgage, and especially in requiring the affidavit of both parties, in addition to the duly certified acknowledgment.

Recording Chattel Mortgages

A mortgage of personal property must be recorded in the office of the county recorder of the county in which the mortgagor resides, if the mortgagor be a resident of the state, and it must also be recorded in the county in which the property mortgaged is situated, or to which it may be removed. I remember a case a short time ago where the mortgaged property was in Los Angeles County, and the mortgagor resided in Riverside County. The claim was set up on behalf of some third person that, although this mortgage was in due form, and had been duly recorded in Los Angeles County, it had not been recorded in Riverside County where the mortgagor resided, and therefore the mortgage was not good, and a third party might buy the property and get rid of it. But in that case the mortgage prevailed, even though the technical requirements of the law had not been complied with. But this decision was owing to some special relation of the parties which made it inequitable to enforce the general rule.

Removal of Mortgaged Property

Again, when personal property mortgaged is thereafter by the mortgagor removed from the county in which it is situated, it is, except as between the parties to the mortgage, exempted from the operation thereof. The man who mortgages his personal property has not the right to move it out of the county without complying with certain rules; but if he does, the mortgage is no longer good except between the parties who made it, unless the mortgagee within thirty days after such removal causes it to be recorded in the county to which the property was removed, or else, within thirty days after such removal,

himself takes possession of the property. It is provided that, if the mortgagor voluntarily removes or permits the removal of the mortgaged property from the county in which it was situated when mortgaged, the mortgagee may take possession and dispose of the property as a pledge for payment of the debt, even though the debt is not due.

Penalty for Unlawful Removal

Under Section 538 of the Penal Code, mortgagors of personal property, excepting certain property used in transportation business, are forbidden, without the written consent of the mortgagee, to remove the mortgaged property, or to cause or permit it to be removed, with intent to defraud the mortgagee, or his representatives and assigns, from the county where it was situated when mortgaged, and they are likewise forbidden to encumber such property, or cause it to be sold, transferred, or further encumbered. And the mortgagor for violation of this law is made guilty of larceny, and is punishable accordingly, unless at or before the time of doing any of the acts referred to, the mortgagor informs the person to whom he makes sale, transfer, or encumbrance, of the existence of the prior mortgage, and also informs the prior mortgagee in writing of the intended sale, transfer, or encumbrance, by giving the name and place of residence of the person to whom the sale, transfer, or encumbrance is to be made.

I find in the reports of the Supreme Court and Appellate Courts of this state just one case where a man was convicted under that section. The conviction was affirmed, and I presume he has had to suffer imprisonment. His offense was the selling of a one-fifth interest in the furniture of a lodging house without notifying the purchaser of the existence of a chattel mortgage.

Validity of Contracts Made in Good Faith

Mortgages of personal property, other than those permitted under Section 2955, and mortgages not made in conformity with the provisions of this article, or portion of the Code just discussed, are nevertheless valid between the parties, their heirs, legatees, and personal representatives, and persons who, before parting with value, have actual notice thereof. In other words, these provisions are for the protection of innocent parties, not for the protection of rogues who would, if permitted, repudiate their obligations because they had not been put in legal form.

The Law of Pledges

Now we will pass from mortgages to pledges. A pledge is a deposit of personal property by way of security for the performance of another act. The Code Commissioners call attention in a note to this section of the Code, to something that I have already mentioned. They state that much difficulty has arisen in determining whether a certain transaction is a pledge or a chattel mortgage, the question generally being whether or not the title has passed. In this state, title never passes in case of property mortgaged or deposited as security; and whenever the possession of personal property is transferred as security only, it is to be treated as a pledge. Even a chattel mortgage, when the possession of the property mortgaged is transferred, becomes a pledge. Possession is the criterion. Every contract by which the possession of personal property is transferred as security only, is deemed to be a pledge. The lien of a pledge is dependent on possession. Now notice that difference. A mortgage, or the lien of a mortgage, is not dependent on possession. Its security is obtained, not by taking the

thing, but by taking the paper which refers to it and describes it, and recording that paper in some place designated by the law for public notices. The lien of a pledge is dependent on possession, and no pledge is valid until the property pledged is delivered to the pledgee, or to a pledge holder.

One who has a lien on property may pledge it to a third person to the extent of his lien. For example, A is a creditor of B; A has a lien upon B's property—he may have his horse or his cow in his possession as a pledge. A needs money; he wants credit somewhere. He may pledge that horse, or that cow, to C to the extent of his lien, that is, to the extent of the debt already secured thereby.

Re-pledging of Property

"One who has allowed another to assume the apparent ownership of property for the purpose of making any transfer of it, cannot set up his own title to defeat a pledge of the property, made by the other, to a pledgee who received the property in good faith, in the ordinary course of business, and for value." (Civil Code, Section 2991.) This refers to another relation that may exist between persons in regard to property. You put your property in the hands of another person, allowing him to assume the apparent ownership of it; and you do that for the very purpose of enabling him to sell it; but instead of selling it, he pledges it. That is the situation already described, and the pledge is good provided the pledgee has acted in good faith.

The Pledge Holder

A pledgor and pledgee may agree upon a third person with whom to deposit the property pledged, who, if he

accepts the deposit, is called the pledge holder. There are certain rules regarding the duties of a pledge holder, but these details may be omitted here.

Misrepresenting Value of Pledge

Where a debtor has obtained credit, or an extension of time, by a fraudulent misrepresentation of the value of the property pledged by or for him, the creditor may demand a further pledge to correspond with the value represented, and, in default thereof, may recover his debt immediately, though it be not actually due. That, of course, is just. A man borrows money on 90 days, or has purchased goods on 90 days' time, and he has pledged something which he represented to be worth the amount of the debt, or 90 per cent of it, or whatever is required, and his word is taken without investigation; but it turns out the next week that he has pledged property that is practically worthless, or is worth only 5 per cent of the pledge; in other words, the creditor has been imposed on. What shall he do? He has given 90 days' credit. The law says that the implied obligation to wait 90 days is cancelled by reason of the fraud, and the creditor may act at once, and say, "You must make good your promise as to the value of this pledge; you must give me other security equal to the value that you represented in this case; and if you don't do that, I will proceed immediately by legal means to collect upon that debt, just as if the contract had read, 'I promise to pay on demand.' "

Sale of Pledged Property

Some of you may like to know the precise rules covering sales and pledges; and the shortest and most accurate way is simply to read the written law. "When performance of the act for which a pledge is given, is due,

in whole or in part, the pledgee may collect what is due to him by a sale of the property pledged."

But before pledged property can be sold and after the performance of the act for which it is security, is due, what must the pledgee do? He must demand performance from the debtor if the debtor can be found. What we call "snap judgment" is not permitted in law, even though the debtor is delinquent, and has failed to keep his promises. If, however, the pledgee has made his demand for performance, and still the debtor does not pay, the pledgee has complied with the requirements of the law as to demand, and may realize upon the pledge by selling it if he will. First, though, the pledgee must give actual notice to the pledgor of the time and place at which the property pledged will be sold, at such reasonable time before the sale as will enable the pledgor to attend. This is very important and necessary, because in sales of personal property there is no subsequent right of redemption as there is in the case of a mortgage.

Notice May be Waived

Notice of sale may, however, be waived by a pledgor at any time, but is not waived by a mere waiver of demand of performance. I have shown you how the pledgor is entitled to a demand of performance before a sale, and he is also entitled to a notice separate from the demand of performance, though they may both be made at the same time, or very close together. A debtor or pledgor may also waive a demand of performance as a condition precedent to a sale, by a positive refusal to perform after performance is due. That is clear enough, I suppose. He has the right to demand notice before sale; but if he says to the creditor, "I will not pay; I'm through with you; I don't intend to pay," he has made a positive

refusal, and no formal demand of performance is necessary on the part of the creditor.

Manner of Selling Pledged Property

Now as to the manner of sale of pledged property. The sale by pledgee of pledged property must be made by public auction in the same manner, and with the same formalities, as provided in the Code for the sale of personal property under execution. The pledgee cannot, however, sell any evidence of debt pledged to him, except where he holds the obligations of government, states, or corporations in pledge. Those he can sell; but in any other case, he simply may collect them when due. There are also legal provisions for the payment of the surplus, if any, to the pledgor after satisfaction of the debt. Instead of selling property pledged, under simple notice of sale, without going into court, the pledgee may go into court and sue on his claim and obtain a decree of sale, thereby foreclosing the right of redemption. After this the procedure is the same as in the case of a mortgage foreclosure sale.

Special Lien of the Vendor

"One who sells personal property has a special lien thereon, dependent on possession, for its price, if it is in his possession when the price becomes payable; and he may enforce his lien in like manner as if the property was pledged to him for the price."

Labor Liens

Now as to special liens on personal property. Section 3051 of the Code provides a lien, dependent on possession, for compensation for services rendered by labor or skill employed on personal property. I called your

attention in the beginning to the fact that liens are granted in two ways: one by contract, and the other by operation of law. The mortgage and pledge liens that I have discussed so far have been practically all liens by contract. I think that what I am about to quote will furnish an illustration of liens by operation of law. "Every person who, while lawfully in possession of an article of personal property, renders any service to the owner thereof, by labor or skill employed for the protection, improvement, safe keeping, or carriage thereof, has a special lien thereon, dependent on possession, for the compensation, if any, which is due to him from the owner for such service. A person who makes, alters, or repairs any article of personal property at the request of the owner, and has legal possession of the property, has a lien on the same for his reasonable charges for work done and materials furnished, and may retain possession of the same until the charges are paid." In this case the liens are by operation of law. Not that there has been an agreement that the property shall remain there subject to the pledge, but simply from the relation formed between the parties on account of this work done. The pledgee must have possession, and is entitled to hold it until paid for his services. "Livery or boarding or feed stable proprietors, and persons pasturing horses or stock, have a lien, dependent on possession." And parties conducting a laundry business have also a lien, depending on possession. I suppose many an impecunious young fellow has found that out to his sorrow. Veterinary proprietors, and veterinary surgeons also, and others giving medical treatment to animals, and keepers of garages, all have liens depending on possession. Special rules govern the sale of property where the lien is imposed by law, and such rules should receive careful scrutiny.

Bankers' Liens

Here is the general provision with regard to bankers' liens: "A banker has a general lien, dependent upon possession, upon all property in his hands belonging to a customer, for the balance due to him from such customer in the course of their business." The relations between a banker and his customers are evidently very friendly, as I find but one decision in the entire legal history of California down to date, where Section 3054 is mentioned, and that was merely a mention of its existence. I suppose that the banks are able to enforce their liens without much application to the courts. But it is worth while to note the general provision.

Warehouse Receipts

Credit men occasionally have to do with warehouse receipts. Warehouse receipts are of two classes: first, transferable or negotiable; second, non-transferable or non-negotiable. Under the first of these classes the property is transferable by indorsement of the party to whose order such receipt was issued, and such indorsement is a valid transfer of the property represented by the receipt, and may be in blank or to the order of another.

If a non-negotiable receipt is issued for any property, neither the person issuing it, nor any other person into whose care or control the property comes, must deliver any part thereof, except upon the written order of the person to whom the receipt was issued.

Necessity of Expert Advice

In the present chapter I have tried to cover—at least in its main outlines—the subject of liens on personal property. One could, however, spend months on the subject if he attempted to examine all the situations that may

arise, and the multitude of illustrations that do arise in actual experience. There are extensive text books devoted entirely to liens on personal property. But this discussion is intended for the student of business, not of law; and one of the first things a business man needs to know is that, when a real difficulty arises outside of general business transactions, expert counsel from a competent lawyer is the only safe thing. There is a maxim that a lawyer who attends to his own case has a fool for a client; and, if this is so, what might be said of a layman who attempts to act as his own lawyer.

Conditional Sales

We will conclude with the subject of conditional sales. It is a general principle, as I have tried to indicate, that ownership goes with possession, and a person in possession of property is presumably the owner. He may, however, hold that property in pledge, which condition gives him something in the nature of property rights. Analogous to this, it is sometimes found expedient in the conduct of business to change possession of property by way of sale without passing the title from the vendor. This is called a conditional sale, and avoids the necessity of passing the title to the purchaser and taking in exchange a chattel mortgage with all its formalities and records. This is done in those cases where the purchaser wants to use a certain thing, and is not ready to pay for it and at the same time does not want to take the title and have a recorded chattel mortgage. In such cases the common law permits a contract of conditional sale. Statute laws in some states have tried to prohibit such sales; but in other states—Massachusetts being a notable instance—their usefulness has been recognized, and the legislature has merely attempted to regulate them by making rules

for the protection of the public, and, at the same time, for the protection of the vendor and vendee. One of these rules is that the person who wishes, after selling property under a conditional sale, to take the property back for non-payment, must make a formal demand and give thirty days' notice. The experience of merchants in Massachusetts has been that this method works very well, because usually satisfactory arrangements are made by the debtor within the thirty days.

Rights of Possession

Under ordinary conditions, a person in possession of personal property can claim to be the owner thereof—is, in fact, the owner—and transfer by him is accepted as passing the title. This is a statement of customary fact and not of law, for it is possible that the person thus assuming to act as owner may have stolen the property; or he may have borrowed or hired it for temporary use; or he may be the holder of it in pledge for a debt not yet due; or, finally, he may be merely the purchaser under a contract of conditional sale.

We will now consider the rights of third persons where the person in possession of property holds it under no better right than that of a contract of conditional sale.

The law of California relating to this topic furnishes an illustration of the manner in which the common law prevailing in England, and generally in the states of our own country, has been adopted and applied as the law of this particular state.

Cases on Conditional Sales

The first actual conditional sales case in the California decisions seems to have been Putnam *v.* Lamphier, 36 Cal. 151 (1868). Here the court cites Parsons on

Contracts as follows: "Where the right to receive payment before delivery is waived by the seller, and immediate possession is given to the purchaser, and yet by express agreement the title is to remain in the seller until after payment of the price upon a fixed day, such payment is strictly a condition precedent, and until performance the right of property is not vested in the purchaser"; and it was held by the court to be a general rule that even a bona fide purchaser from the conditional sale purchaser would not take title as against the original seller.

In the case of Kohler *v.* Hayes, 41 Cal. 455 (1871), it appeared that the plaintiff had delivered a piano to one Dowling on an agreement that the same was to be sold to Dowling for a stated sum, to be paid at the rate of $40 per month, and that when the entire amount should be paid, a bill of sale would be given. Dowling, after paying $100 on account, sold the piano to a third person who purchased in good faith without notice of the terms of the conditional sale. It was held that the title to the piano remained in Kohler, and that on the facts he would be entitled to recover possession in default of payment of the purchase price.

In Hegler *v.* Eddy, 53 Cal. 597 (1879), certain household goods were delivered to Alice Cumminsky, to be paid for by instalments. She was to have the right to use the furniture so long as she should pay such instalments; and, upon failure, the vendors might at once take possession of the property, and the moneys already paid were to be forfeited. Held: "This is not a sale but only a contract for the sale of the property, and the legal title to the property is not thereby transferred or changed."

The principles above stated have been approved from time to time down to the latest cases, one of which is Lundy Furniture Co. *v.* White, 128 Cal. 170, where an

instrument in the form of a lease, providing for payment of rents until the amount paid should equal the agreed value of the property (when a bill of sale was to be made), but expressly reserving title in the vendor with right to retake possession upon breach of its conditions, was held to be a conditional sale and not a lease.

Fraudulent Contracts of Sale

Sometimes agreements supposed to be of this kind have been so written that they were held not to be contracts of conditional sale and the title passed to the purchaser, and sometimes such agreements have been held invalid as an attempt to evade the laws concerning the recording of mortgages. For instance, in Palmer *v.* Howard, 72 Cal. 293 (1887). The agreement lacked two of the usual earmarks of a conditional sale: (1) No bill of sale was to be given on payment of the purchase price; and (2) if the purchaser failed to meet the payments, the vendor might take and sell the property; but in so doing he must account for any surplus above the agreed price and expenses of the sale. Here the court said that it must be remembered that the policy of the law is against upholding secret liens and charges to the injury of innocent purchasers; and that mortgages of personal property are permitted only in certain specified cases and under specified conditions, intended to give notice to the world of the character of the transaction and that when such conditions had not been complied with, the court would give effect to the transaction according to its true character, and not by the mere name given to it by the parties.

Again, in other cases—as where a harvester was sold and delivered to the purchaser under an agreement to give notes for the purchase money, and under the terms

of an absolute sale passing title to the purchaser—such absolute sale cannot afterwards be converted into a conditional sale, without any change of possession, by a mere agreement between the parties.

CHAPTER IX

LIENS ON REAL ESTATE*

By Hon. Lee C. Gates

Practical Importance of the Subject

The present chapter is not a technical discussion of liens on real estate, but is intended for business men and students of practical business life. For twenty years and more the institution with which the writer is connected has been engaged in the study of liens, titles, and matters affecting the titles to real estate. All who are interested in real estate, either as purchasers or as encumbrancers, i. e., men who take mortgages and accept liens upon real estate, understand the importance of thorough investigation as to previous liens. Examination of title for the purpose of investment in real estate, is undertaken mainly for two classes of people—those who buy, and those who loan money upon real estate. Men who own property do not as a rule undertake to examine their titles until they are about to dispose of it, and the result is that many properties are sold for liens which, without the knowledge of the owner, have attached thereto.

General Nature of Liens

A lien is a claim that attaches to property, either by contract or by the operation of law. If you loan your

*It is impossible to give the varying lien laws of the different states in the present volume. The California law which is discussed here will give a fair idea of the general law of liens and will indicate what the credit man must look for when investigating the matter in other states.

money on a piece of property, you have created a lien by contract. A tax lien, however, is created by law; a street assessment is also a lien created by law. These are involuntary liens, and many people do not know anything about them. We shall therefore, in our discussion of the general subject of liens, endeavor to ascertain what they are, where they exist, and to what extent and for what length of time they are binding on property.

Taxes as Liens

We shall discuss first the subject of taxes as liens which attach on all property. In the state of California, a few years ago, we adopted an amendment to the Constitution, providing that state taxes were to be levied on the public utility corporations of the state—the power, gas, electric, telephone, railroad, and express corporations—and these public utility corporations were to pay us a certain percentage of their gross income. We also levy a tax on the capital stock and surplus of our banks. We levy these taxes directly upon the property of the corporations, and such taxes become a lien.

The Franchise Tax

Then, there is the franchise tax—a tax levied upon the right to be a corporation. A corporation is a creature of law, brought into existence by general statute, and we impose a franchise tax upon it. Many people doubt the wisdom of this tax, and there is much caviling, much abuse, and remonstrance against it; but it is imposed by our Constitution, and cannot be revoked except by an amendment thereto. This tax, therefore, is a lien on the property of every corporation. If a corporation undertakes to sell a certain piece of its property, any unpaid franchise tax is a lien upon that property—a lien renewed

every year; and if it is not paid one year it does not outlaw like a mortgage, but accumulates. The tax of last year, of this year, and of next year become liens, and continue so year after year. None of them outlaw, and none die. The statute of limitations never operates against a state, a city, or a municipality. An obligation to any one of these is perpetual; and a business man recognizes as a "preferred" lien the taxes standing against the property of either a corporation or an individual. This condition is the reverse of the status of ordinary claims.

The License Tax

In California there is yet another tax—found in few, if any, other states—which is a lien on the property of a corporation; viz., the license tax. Some years ago, in order to raise revenue, a graduated tax falling due every year was laid on the capital stock of corporations. Unless this tax is paid within the time fixed by law, the penalty is not merely a lien on the real estate, but the existence of the defaulting corporation is destroyed. It forfeits its charter. It is no longer allowed to continue business. By its failure to pay the tax, it ceases to be a corporation.

This license tax is something about which most people connected with corporations know little, unless they happen to be trained lawyers who have made a special study of the laws on this subject. Many think when they pay *one* of these taxes, usually the franchise tax, that they have paid *both;* and there are accordingly 30,000 corporations in this state which have forfeited their charters since the license tax law went into effect, and the license tax remains a lien against the property of these different corporations.

Under the Constitution of California as it stood prior

to 1910, no statute could be passed by which a corporation could be revived, so that a failure to pay the taxes in 1907, 1908, or 1909, left that corporation non-existent. It could continue in business, for the law is, that affairs of a dissolved corporation pass into the hands of the directors who are in office at the time of forfeiture for liquidation, but there was no provision in the law by which it could be resurrected. To remedy this we had to adopt the constitutional amendment of 1910, providing that a corporation could be revived by the payment of its taxes and of all the penalties accrued against it. Now upon the payment of such taxes to the Secretary of State, and the issuance by him of a certificate to that effect, a corporation is reclothed with its powers. In other words, it can die, and then be resurrected by the payment of a tax.

The license tax has brought annually into the treasury of California something like $800,000, but now we want to abolish it, principally because of its disastrous consequences.

The Poll Tax

There is another tax in California which, though not a property tax, becomes yet a lien on real estate owned by the man who fails to pay it. That is the poll tax of two dollars on every male citizen of the state. A petition to abolish the poll tax is being circulated, but the movement is of doubtful wisdom. It is worth two dollars to be a citizen of the state of California; and moreover, the proceeds of this tax form a part of the fund that has been used to build up our public schools. Its abolition would mean the loss to our treasury of another $800,000.

Your poll tax if not paid gets to be $3 and $4, becoming a lien on the real estate of the man who owes it.

Many a time when property has been sold, the purchaser has found that the poll tax has not been paid, and that a lien attaches to the property and must be paid later. Sometimes property has been sold because of this unpaid poll tax. I have happened upon many cases where the poll tax with the costs made a considerable sum to be paid in order to release property.

Selling Property for Taxes

It will be understood that when you buy property on which the taxes have not been paid, there is a tax lien upon it—an involuntary lien. You cannot escape it. Taxes are levied and they become a lien. You have to take care of them, or your property will be sold.

Under the California law passed in 1897, all property in such cases is sold to the state. Up to that time it could be sold to any man who would pay the taxes on any particular piece of property, in return for a certain proportion of that property, the successful bidder being the one content with the smallest amount. Sometimes it happened that a man would offer to pay the taxes on a piece of property on one of our streets, for the front inch of the property. Some other man would say, "I'll take a half inch," and another, "I'll take a quarter," bidding against each other, until it reached a point where there were no numbers left to register the bids. Well, the one offering to take the least would get it; and he would get a tax certificate, and later on, a tax deed, if it were not redeemed. Of course, you can understand that there is no proper use an individual could make of a millionth of an inch of land even on Spring Street or Broadway, and this custom led to abuses. Now, therefore, the state becomes the purchaser of all property sold for taxes. It takes a certificate of purchase after one year; and after five years it gets a deed, and can sell the property.

Abuse of Private Tax Sales

Under the old law there were men who made it a business to buy tax sales, attending regularly when the sales were held, and buying all they could. They then got tax deeds, and in time it became a question whether their title could be sustained by a suit, or whether they would accept a certain sum of money and let the property go. This grew into a very pernicious and disgraceful practice. There were "tax sharps," as we called them, who, after they got a deed costing $1.25, or $1.50, or $3, would ask $100 for a quit-claim deed to convey back the interest thus obtained, and so manage the matter that it was cheaper to pay than fight.

So far was this carried that it became necessary to amend the law; and later, we passed an amendment by which the state bought all the property, and then we got rid of that practice forever.

Tax Titles

Tax titles, I may observe, have been throughout all history a very precarious class of titles. Very few tax titles have ever been held valid in the state of California, or in fact, in any other jurisdiction. You cannot buy a tax title with any degree of certainty that the owner will not be able to set aside your title and recover his property. Recently the courts have upheld some few tax titles; but you can usually set aside a tax sale, though you may have to expend several times the amount of money that redemption would have cost. Usually it costs less to buy off the owner of the tax title than it does to bring a suit and go through the various courts to a final decree.

City and Special Taxes

In California there are so many liens included under

the head of city taxes that I have not space to enumerate them. We have the street lien, the sidewalk lien, the sewer lien, the shade tree lien, the protection district lien, the school district lien—and all these assessments must be taken care of and watched.

When you go out into the country you find matters but little better. There are already sanitation tax districts, and recently a bill has been proposed, which, if passed, will levy a tax on the real estate in a certain district for the prevention of the flow of water into oil wells. Taxes and assessments are, in fact, almost limitless in number; and any property owner or business man must be very careful to ascertain what they all are, or he will find his property sold, and will have to pay a large amount of money, comparatively speaking, as the penalty for allowing it to be sold. Indeed, I might say things have reached the point in California where, if you desire to escape liens of taxes or assessments, you have to hire a lawyer, and a good one, or you will be mulcted.

The Inheritance Tax

Still another kind of tax is the inheritance tax. We are increasing the taxes on inheritances, though we are still a little behind other countries in that respect. The tax on the property of the man who dies is the only tax that no one ever pays; for certainly the man that dies does not pay it.

A few years ago an indignant young fellow came to my office desiring me to prevent the levying of a tax in the state of Illinois on an inheritance which he had received from an aunt. The amount of money was $30,000, and he was outraged to think that the state of Illinois wanted to take something like $1,800 of it, leaving but $28,200 for him. He wanted me to bring a suit.

He said, "They have no right to take that money from me." "Why," said I, "they didn't take it from you. Did you ever have it?" "No," he answered, "but my aunt gave it to me." "All right. Your aunt didn't give you all of it. She couldn't. The state of Illinois said she could only give you $28,200, and you are getting it. You don't pay that $1,800, for you never had it; and your aunt doesn't pay it, because she has passed away."

The whole matter of inheritance is a matter of statute. Unless the statute said so, your children could not inherit one dollar. If there was no law on the subject, and I died, my property would go to the state. There is no natural right to inherit. That being true, the state can tax property which passes from a decedent to the heirs in such sums as it sees fit. Large fortunes should be taxed heavily. If a man dies leaving several millions, the state ought to receive a very large share of it, because no one can make a million dollars; he only obtains it by virtue of the operation of the laws which have permitted him to do so.

Judgments

All tax liens are involuntary liens—liens you must care for, or your property will be forfeited. Now I want to take up another lien, which partakes of the nature of an involuntary lien; that is, an attachment, including all such claims as come under the general head of "Judgments and Attachments." Under the California law a judgment obtained by one party against another in a suit becomes a lien on all the real estate then owned by the debtor, or acquired by him thereafter during the life of that lien. A judgment operates instantly on all the property in the county, and, if the debtor has property in another county, the man who obtains the judgment—the

judgment creditor—can send a transcript of that judgment into that county and have it levied there. But if a judgment is obtained before a justice of the peace, it does not become a lien on real estate until an abstract of the judgment is recorded in the recorder's office. A judgment rendered by a court of record, when docketed in the county clerk's office remains a lien on all the property for five years, and may be renewed at any time after five years upon suit brought for that purpose, or at any time before the five years have elapsed, by a mere motion. At the end of five years you may issue an execution of judgment and levy upon property, selecting any particular property you desire. The lien of the judgment becomes the lien of levy and execution, and, on the sale of the property by the sheriff, it merges into the certificate of sheriff's sale.

Sheriff's Certificate of Sale

Now, up to the time of the issue of such certificate the judgment is not a lien against a deed, though unrecorded. For instance, if Mr. Blank held from me a deed which he had not placed on record, and some one of my numerous creditors were to sue me, get judgment against me, and levy an execution on the property standing in my name, Mr. Blank could come in and put his deed on record; whereupon the judgment lien would be found inferior to his deed. But if he waited until the sheriff's certificate of sale had been made and issued, such certificate would take precedence. The sheriff's certificate of sale remains a lien until the end of the year, during which time the owner may redeem his property, and after that time it merges into a deed, and title passes.

Attachments

Antecedent to the judgment is the attachment. A man

desiring to obtain a judgment against a debtor, may, under certain circumstances, attach a particular piece of property. Such attachment becomes a lien, which holds that property as against any other attachment or any other lien, mortgage, deed of trust, or otherwise, until the judgment is either rendered or denied. If the suit results in a judgment of non-suit, that is, if the plaintiff gets no judgment, this decision instantly dissolves the attachment; but if he gets a judgment against the man whose property he has attached, that judgment becomes a lien not only on the particular property attached, but also on all the property owned by the judgment debtor in that county.

The Homestead Exemption

Now that attachment is a lien. It is not, however, a lien as against an unrecorded deed of date prior to the attachment; neither is it a lien as against a homestead, which may be declared by the owner of the property even after an attachment has been levied. This is another peculiarity of our California law. The homestead exemption is not an involuntary proceeding. In many of the states, when one takes property, the homestead right attaches instantly; but in the state of California there is no homestead until the owner of the property, or the person who claims an interest in the property, makes his declaration of homestead and files it in the recorder's office. So that, if my property were attached tomorrow by some one of my numerous creditors, tired of listening to my excuses, I could defeat the attachment by levying a homestead lien upon my property, whereupon the attachment would go for naught. But if I waited until that creditor got a judgment, the homestead exemption would be of no value.

The Torrens Land Law Registry System

The Torrens Land Law Registry System, which has been on the books in the state of California since 1897, is a system by which each owner may have his land certified by the county recorder, as the registrar, who gives him a certificate. Now, under this system, the man who gets a judgment does not have a lien on all the debtor's property in the county, but only on those lands which he knows to be the debtor's property. He has to go to the recorder's office and select the lands.

The Torrens Land Law Registry System has never been very effective in this state and an endeavor is now being made to amend and improve it. If the proposed amendment goes into effect, it will greatly modify the present conditions, of which the limited judgment lien is one feature.

Benefits of the Mortgage Lien

I come now to the mortgage lien—the most familiar of all. There are few people who are entirely unacquainted with mortgages. It is a very poor man indeed, and a very thriftless man too, who has never been able to borrow money on a mortgage. The whole advance of commercial civilization has been on borrowed money, and while we have come to look on a man who loans us money on our real estate as an enemy, there is, in my opinion, no more misleading and mischievous idea. The laws which give to the creditor the protection of this security enable him to loan his money to the individual who can furnish that security, the two men working hand in hand. I might say that our banking fraternity—the men engaged in receiving the idle moneys of the country and turning them into the channels of trade—are performing a very valuable service for the people of the communities in which they live.

Trust Deeds

A trust deed given to secure borrowed money is not technically a lien on the land it covers; it is a conveyance of the title to secure the loan. It is, however, really only a form of mortgage—though not so called—and is very frequently employed. There is a provision in our statutes which says that a conveyance of title as security for a debt, whatever its form, is in effect a mortgage, so that if you take a deed from me as security for a debt of $500, that deed, while it appears to pass title on its face, is, in fact, only a mortgage; and if you want to get the property, you must go into the courts and foreclose it as though you held a mortgage.

Now, under our theory of law in California a mortgage is only a lien. It does not pass the title. In some other states the mortgage passes the title—a mortgage is simply a conveyance of the title; and the mortgagor can compel the mortgagee to transfer it back to him when he pays the debt. The lien theory of mortgages, however, is that on which we proceed in California; and, therefore, a deed taken to secure a debt does not really convey the title. Now observe the possible result of this: If Mr. Blank takes a deed from me to secure a loan of $500, the law says I still have the title although he has the deed, for he has in effect only a mortgage; but if he sells the property to some third person who does not know anything about it, and who buys it in ignorance of the fact that I still have the title, the law very properly says that this innocent purchaser from Mr. Blank gets the title. In other words, Mr. Blank is able to give the other man something that he never possessed. This is necessary for the protection of the innocent purchaser, for no man would be able to buy property without security except under such protection.

Deed Not Effective Until Delivered

Delivery of property by a deed of title does not pass until the deed has been delivered. It is a common thing for a husband to make out a deed to certain property in favor of his wife, and to put that deed into a safe waiting for one of them to die, intending, in the event of death, to put it on record. Now, if that deed is delivered either to the grantee or to a third person, with instructions to that third person to deliver it to the other upon the death of the grantor, the title will pass when the second delivery is made. That is a delivery in escrow. But sometimes a man makes out his deed, puts it in his safe, and leaves it there, or sometimes the husband and wife make out two deeds and put them in the safe, agreeing that the title shall pass to the survivor and in such cases there is no delivery. If, under these circumstances, the wife should die, and the husband should put her deed on record (destroying his own deed), that deed is absolutely void. If he gets it on record, and no one knows about the destruction of the other deed, or if he can apparently prove that that deed had been delivered to him, he may hold the property; and yet, if any of the heirs could prove the facts to be as I have stated, they could set aside the deed.

In other words, no deed is effective until it is delivered. If I made a note for $500 to Mr. Blank, and left it in my desk, and never delivered it to him, he would not have my note, and could not collect on it; just so with a deed. Even if written instructions were placed in the safety depository directing the deed to be delivered on the death of the grantor, the delivery would not be good. The deed must be delivered, either to the grantee, or to some third person. The only safe way, if a man wants to turn over his property to his wife on his death so as to save administration papers, is to make out a deed, take it

to his bank, put it in an envelope, and write on the face thereof: "This envelope contains a deed of certain property therein designated. You will hold this deed until my death. You will then deliver the same to my wife." Then, when that deed is delivered, the title will pass.

Law of Mortgage Liens

A mortgage becomes a lien from the time it is filed for record in the recorder's office; and it is a lien as to anybody who knows of its existence, even though it is not filed of record. In other words, you have constructive notice of the mortgage by the filing in the recorder's office; but if you know that mortgage is in existence, you have actual notice and are bound by it, regardless of whether it is filed or not.

Legal Expiration of Mortgage Liens

A mortgage lien attaches the moment it is filed for record in the recorder's office, and it continues until the time of its expiration, and for four years afterward. That is, a mortgage does not outlaw until four years after the date of its maturity as fixed by the court. The note, of course, is the principal obligation. The mortgage is merely an incident—a security for the obligation. There is yet another interesting feature. Many times when a note has passed beyond maturity, the lender and the borrower are willing that the mortgage security shall be renewed without making out new papers. They can do it by entering into an agreement to postpone the payment of that mortgage to a future time. But can they carry it beyond the time when the original papers would outlaw? They can, provided there is no other mortgage or lien after the mortgage which they are thus renewing. But if there is a second mortgage on the property, the old

mortgage cannot be renewed for a longer period than it would run without renewal. In other words, you cannot renew it beyond the four years after maturity. If you make it longer than that, the second mortgage becomes a first lien, and the first mortgage becomes a second lien.

Lien of the Deficiency Judgment

When a suit is brought to foreclose a mortgage, and the property has been sold for less than the mortgage debt, there comes into being the deficiency judgment. This is a judgment entered and docketed, but which does not become a lien until after the sale has been made, and the deficiency ascertained and put on the docket in the clerk's office. It then becomes a lien on what? It is not a lien on the property which has been sold by the sheriff, unless the owner redeems it, when it will instantly attach as a lien. To exemplify, if Mr. Blank had foreclosed a mortgage against me, and after that I came in and redeemed the property which had been sold to him, by paying him the purchase price and one per cent interest on it, the deficiency judgment which he had against me would instantly become a lien on the property in my hands. But if I should sell to some one else an equity in the property, and that person redeems, the deficiency judgment does not become a lien. So where there is a deficiency judgment, the judgment debtor rarely redeems if he consults an attorney.

Rights of Second Mortgage

There is another curious feature of the law, which resulted some years ago in the loss of a lien by a very capable lawyer, who had neglected to look up the law in the matter. A man had a second mortgage, and in a suit which was brought by the first mortgagor to foreclose,

he went into court and asked that the court foreclose his mortgage also, which he had a right to do by cross complaint. This was done. When the property was sold it brought a little less than the face of the first mortgage. The second mortgagee then offered to redeem, but according to the law he could not redeem because he had no lien on the property. He had foreclosed his mortgage and it was no longer a lien. He lost out because he had done the wrong thing in foreclosing. If he had gone into the suit and asked that any surplus after the sale of the property under the first mortgage be paid upon his own mortgage, he would have had a right to redeem, because he would still have had a mortgage; but having passed his mortgage into a decree of foreclosure, it was no longer a lien on that particular property, and he could not redeem.

In California a mortgage when foreclosed takes title when the sheriff's deed has been issued; and we have extended the time of redemption from six months to a year.

Law of Trust Deeds

Now let us go back to trust deeds, which, as I said, are not liens, but take the place of liens. At nearly every session of the legislature there is an agitation about repealing trust deeds. When you make a trust deed you pass the title to the trustee—usually a third person, although I can make a trust deed to Mr. Blank covering my property, for a debt owing to him, and he then becomes both the debtor and the trustee. Our law has sanctioned this procedure, but as a rule a deed of trust is made by A to B for the benefit of C. A borrows of C, say, $2,000. He makes a deed to B of the property which is to be the security for the payment of that debt, and he gives to B the power, in case he himself shall fail to pay the money, to sell that property upon a compara-

tively short notice and in a comparatively expeditious way, and pay the debt. In other words, deeds of trust, as now drawn, usually provide that if the debtor fails to pay, or makes default in the payments required under the deed of trust, the trustee may publish a notice for six weeks in some newspaper. When the property is sold at the end of that time, the title passes immediately to the purchaser, without any right of redemption on the part of the maker. That is too harsh, you say, too dangerous; you can sell a man out in too short a time. But you cannot sell him out unless he fails to pay his debt, or defaults in his payment. If he makes his payments, the trustee has no power whatever.

Advantages of Trust Deeds

Now I will show you how the trust deed works in the upbuilding of a new country. For example, there are thousands of tracts of land now being opened around the city of Los Angeles, and the owners of those tracts divide them into lots, and build houses on the various lots. They sell each house and lot to an individual, who is usually a man of limited means. We will say that such a house and lot is worth $2,500. The owners of the tract will be able to borrow from a bank possibly $1,500 on that house and lot. They give a mortgage to the bank for that amount, and that is a first lien. The owners will then sell to the individual purchaser, and allow him to pay perhaps $250 down, taking a deed of trust from him for the remainder of the purchase price, which is to be paid back on instalments. These payments are arranged so that the purchaser can make them out of his limited means without too much difficulty; and hundreds and thousands of homes are being paid for in that way.

Now, would the owner of the property be able to do

this in any other way? Could he take a second mortgage, allowing the purchaser to pay it back in instalments? In that case, if the purchaser were to default in making his payments, the owner of the property, the seller, would lose heavily. He must have such an instrument that he can quickly take the property back in case the individual fails to make his payments, otherwise he could not afford to sell on such terms. If he had to take a second mortgage to secure his claim on the property, and the man defaulted, what would he do? He would have to hire a lawyer, he would have to go into court and bring a suit, and then wait three or four months. He would then have to sell the property after it had been advertised for three weeks, and then wait a year before he got possession, because the purchaser would be in possession, and you cannot take property away from the legal owner under a full year. If we were without the security afforded by the trust deed for the owner who sells his property on small payments, it would be eighteen months before he could get his title back in case of default; and if the purchaser had to give a second mortgage, he would have to put up $500 or $1,000 for it, and under these hard terms, thousands of poor men would be unable to begin payment for a home. Now that is a part of the deed of trust theory. A deed of trust passes the title; but there is an expeditious method by which the owner can recover his property after a default has occurred and the purchaser has failed to make his payments. Once in a while the owner of a debt will be harsh, and he will declare a default within a few days after the debt becomes due; but in the large majority of instances the owner is willing to allow a man 30 days in which to make his payments, and trust deeds are so written in a good many instances as to give the purchaser fifteen days of grace.

The Vendor's Lien

There is another lien which is very little known, and often misunderstood. This is the vendor's lien on real estate. If I sell a piece of land, and do not take all the purchase price, I have a vendor's lien on that property in case I take no other security; but if I take other security, I have no lien. This vendor's lien is involuntary, but is little used in California. That is perhaps a fortunate circumstance, because it is so indefinite that no one can know exactly what his rights are under such a lien.

The Mechanic's Lien

We have not yet mentioned the mechanic's lien. The State Constitution provides that mechanics, material-men, etc., shall have a lien for the material furnished and for labor that has been performed. Some people think that we ought to have a mechanic's lien law that would give to the laboring man and the material-man the first lien on the property which is created by them, over and above a mortgage or deed of trust which secured the loan, and which antedated the beginning of the building. They say that it is the habit of mortgagors and trustees to slip in a mortgage just the night before the building is begun, and thus get a lien ahead of the mechanic's lien. It is, of course, a well-known principle of law that a mortgage or a deed of trust will take precedence over a mechanic's lien if it is filed before the building is begun, or before the material is on the ground. This is necessary, because nearly all building operations are undertaken on borrowed money, and the money which pays for the material and the labor is therefore, in most instances, borrowed money; and a large part of our building operations would cease entirely if we could not borrow the money with which to carry them on.

The Mechanic's Lien Law

The mechanic's lien law has passed through many vicissitudes. The Constitution provides that mechanics and material-men shall have a lien. It also says that the legislature shall provide by suitable legislation for the enforcement of these liens, and the Supreme Court has held that no law existed for the enforcement of such liens until the legislature took proper action, and, although the Constitution declared that the mechanic had a lien, he actually had no lien. Laws have been passed for the enforcement of this lien, but the legislature at nearly every session is confronted with a number of bills for the amendment of these laws; and there is a bill under discussion now. The owner can file his contract; but the material-men, the contractor, the laborer, and the artisans, may have their liens on the property; and if, under this bill, they can show that the owner has been in fraudulent collusion with the contractor, the mechanic's lien may be greater than the contract price. You have to bring suit within ninety days, and that suit when brought is to be tried in the manner in which the courts have tried these cases. You can consolidate all of them, and try them all in one suit.

I am not very familiar with the actual working of the mechanic's lien law, because my practice has not carried me into the courts in that respect; but, speaking generally, it is, in my opinion, a very valuable law. This, together with the trust deed law, has enabled us to build up the southern part of California, because the men who furnish the material and perform the labor feel that they have a lien on the property on which they are to expend that labor and material, and that they will be paid even though the owner shall refuse to pay them.

CHAPTER X

FRAUDS

By W. J. Ford

Fraud Not Always Legally Punishable

The subject of frauds engages the attention of the district attorney's office more, perhaps, than any other class of offenses against the community. Nevertheless, the number of prosecutions is limited, for the reason that there is a large class of frauds for which the law affords no criminal remedy, and in many cases where the law does afford such remedy the prosecution is so restricted by the rules of evidence as to render conviction very difficult. In cases where people have obtained money under false pretenses—the most common form of fraud and the one most difficult to deal with—we have really very few prosecutions.

The Several Varieties of Fraud

Fraud, as a generic term, includes all acts of omission and concealment injurious to some person which constitute a breach of the trust or confidence justly reposed by that person in the one guilty of the fraud, or acts by which an undue and unconscionable advantage is taken of another. Actual and positive fraud consists in circumventing, cheating, or deceiving a person to his injury, by any cunning, deception, or artifice. The term "legal fraud" has been used to characterize the false representations, more or less innocent, which are reckoned suffi-

cient ground for rescinding a contract through a civil suit. A "constructive" fraud is held to be an act which, regardless of the motive of the perpetrator, the law declares to be fraudulent in itself. Such law is justified by the fact that certain acts carry in themselves irresistible evidence of fraud, or are liable to lead to frauds which can better be guarded against by declaring all cases that come within the operation of a particular statute, frauds in themselves or constructive frauds.

Contract to Sell Property

For example, a contract with a real estate agent for the sale of a piece of property must be put in writing before the agent can collect his commission. If an agent sells a piece of property for another without such contract, the law will not permit that agent to collect his commission, even though the agent is attempting to get what really and morally belongs to him. The law does not regard a verbal contract as valid in such cases; for it violates the statute of frauds.

The reason for this ruling is that a man may come in and voluntarily offer his assistance in a transaction, though neither of the principals has really employed him in any capacity and neither of them desires his assistance. If it were not for the statute of frauds such a man could, to use a slang expression, "butt in" on a transaction uninvited, and then attempt to collect commission.

But it is not this class of frauds we are now to discuss. The subject of the prevention of fraud covers a wide field, and only a few special cases can be taken up here.

Frauds Punishable by Statute

There are many frauds which, according to the statutes, may be punished criminally. Such is that of

marrying under false pretenses, or obtaining money or property by impersonating another in a private or official capacity. Conveyances made with the intent to deceive or defraud, as for example, to deceive, hinder, or delay creditors, are punishable. We have statutes against selling land twice, by which legal penalties are provided for anyone who enters into a contract to sell a piece of property to A, and who before that contract has been abrogated, contracts to sell it to B or C. We have statutes forbidding married persons to represent themselves as competent to sell real estate without the concurrence of the wife or husband in cases where such concurrence is legally required. There are also statutes against false statements concerning the prices received for consignments of goods, commission merchants being required to make true statements to their principals as regards such property. Also, the statutes prohibit the removal of mortgaged personal property from the county where the mortgage is recorded, and mortgaged property may not be further encumbered without notifying the owner of the prior mortgage, and also notifying the second mortgagee that there is already a first mortgage.

These are only some of the more familiar laws against frauds. All the special statutes against fraud exist in addition to the general statute forbidding the obtaining of money under false pretenses. It would seem that the laws concerning frauds, and making them punishable through criminal prosecution, are broad enough to cover every species; and yet they actually cover only a small proportion of the frauds that are a matter of daily occurrence.

The Confidence Man

In addition to the criminal offenses specifically desig-

nated as frauds, we have the various devices used by confidence men and bunco steerers for obtaining possession of the property of others, which are usually prosecuted and charged as larceny. Some of these schemes are familiar to you. There is the old-fashioned one of selling a gold brick, or green goods, while a more modern trick is that of parting the "sucker" from his money by means of a "fake" lottery or other gambling schemes. Often such a victim is ashamed to appeal to the police until it is too late to secure a clue to the whereabouts of the rascals.

Another device as old as telegraphy and horse racing is for the swindlers to make acquaintance with some stranger and inform him that they know where there is a pool room in operation; that they have a friend who has tapped a telegraph wire or is an operator, and who can delay the transmission to the pool room of the messages showing the winning horse until they have had time to go in and put up a good substantial bet on the real winning horse; and that by means of this device they can defraud the pool room. The "sucker" finds out that they have defrauded him instead before they get through.

Of course the ordinary business man, if he is wise, will never come into contact with just such tricksters as these; and I mention them merely to give a general idea of the fraudulent schemes most common, and of the efforts of the law to guard against them in specific instances.

Obtaining Money by False Pretenses

Let us turn now to the classes of frauds with which business men are particularly concerned. When you meet a prospective customer you naturally inquire into his character. You want to know something of his general honesty, of his ability to carry on the business in which he

is engaged, of the class of customers he sells to and of his promptness in paying his own debts and in collecting moneys owing to him. In other words, you want to find out if he is a good business man and, in addition to that, you want to ascertain what assets and liabilities he has. These are some of the inquiries which must be made to determine matters concerning credit. In case of mistake there is practically no redress, although the law does provide some remedy, both criminal and civil, for those from whom money has been obtained under false pretenses.

Proof of Fraud

In cases of false representation there are several points which must be established beyond all reasonable doubt, and it is these points that the credit man should always look into; though, of course, he cannot under all circumstances guard himself against an untruthful man. As a rule, a man who has some standing and who wishes to obtain credit from a mercantile or banking institution, is one in whom the credit man has confidence. But if he lies as to certain facts, the creditor may proceed against him by criminal process. It is important, therefore, to understand just the elements which constitute the crime of obtaining money under false pretenses.

First of all, there is the representation or pretense which the applicant for credit makes, which must be a representation as to an *existing fact,* or as to *some fact that has existed in the past.* Representations as to what is likely to occur in the future are not punishable by law. The law does not require any man to be a prophet as to the future, and he cannot be prosecuted because his judgment proves bad as to what the future may bring forth.

If I tell you that during the last month I have sold one thousand dollars' worth of goods, I have made a

representation as to a fact that has existed during the past month. If I tell you further that I have in my grocery store so many cans of different kinds of fruit, so many boxes of goods, etc., and give you an inventory, or an approximate inventory, of my stock, then I am making a representation as to an existing fact; and if these statements are false, and you extend credit to me on the strength of them, I come within the law against obtaining money under false pretenses.

Opinion Cannot be Construed as Misrepresentation

But such representation must be a representation as to a fact, and not an opinion. If I represent to you that in my store I have certain fixtures, it may be that you are so situated that you cannot go to the store and look at them, and so you rely on my representation; and if I have misrepresented what I have in my store, I have made a misrepresentation as to fact. But if, on the other hand, I tell you that the goods and fixtures which I have in my store are worth $3,000, when, as a matter of fact, in the market they may be worth only $1,500, I am not misrepresenting a matter of fact but merely stating an opinion.

Take another example that will illustrate the point a little better. If I tell you I own a lot and that it is worth $2,500, when the lot can really be bought for $1,600 or $1,800, I am making a misrepresentation as to opinion. In my opinion it may be that the lot is really worth $2,500, but it may be also true that you can get just as good a lot for $1,600. The representation which I have made is a matter of opinion for which I cannot be prosecuted, except under rare circumstances. If I represent to you, however, that I am the owner of the lot when, as a matter of fact, I am not, or if I represent to you that the lot is free and clear when, as a matter of fact, I have

a mortgage on the lot, I am making a misrepresentation as to a fact and can be prosecuted.

It sometimes happens, however, that a representation as to a matter of opinion is so grossly incorrect that the Court will declare it a misrepresentation as to fact, particularly in matters involving opinions as to values. For instance, a lot in some little suburb, or some new town that exists only on paper, may actually be worth about $75. Some stranger may be informed that that lot is worth $10,000 or $20,000. The courts have sometimes held that under such circumstances the person who made the representation could not have honestly entertained the opinion that it was worth two or three hundred times its actual value, and have held that such a misrepresentation as to value is a misrepresentation as to opinion, and that the purchaser is entitled to protection against misrepresentations of such character.

The business man must, however, for the most part look out for himself in such matters and be careful to observe whether a misrepresentation deals with facts or with opinions and whether it represents facts as they now exist, or have existed in the past, not as they may be in the imagination of the promoter or the persons engaged in business, and not as they may exist in the future.

Statement Must be Known to be False by Maker

The person who makes a false representation must know that it is false or he cannot be held liable. A person who innocently makes a misrepresentation is guilty of no crime, even though his misrepresentation may result in a loss to others. He must either know that it is untrue, or he must represent something as true of his own knowledge, when, as a matter of fact, he does not know anything about it. Either of these conditions will make him

liable under the law. When a man knows his statement is false it can usually be proved by showing that he was familiar with the subject, and in a position to know if he wanted to. As a rule, the law presumes that men are sane, and that, if they are in a position where they ought to know, they do know.

Intent to Defraud

A misrepresentation must be made with intent to defraud. If it is made to somebody who is merely inquiring into your business affairs, and who, as you think, has no business to inquire into them, and you make your misrepresentation to him only with the intention of misleading him, you are not guilty of any crime, because the misrepresentation must be made with the intent to defraud.

Creditor Must Rely on Misrepresentation

There still remains something before the crime of false representation can be established. The person from whom the money was obtained must have believed the representations. If I come to you and tell you that I am the owner of the lot next door, and you know that some one else owns it, you must not extend credit to me thinking you can prosecute me criminally, or that you have a criminal hold on me. You know better; you know I do not own it; and the law does not allow you to hold anything over my head. You must believe and rely on the representation that is made to you.

Now, by relying on a representation that is made to you, I do not mean that it is necessary that you should abstain from making any investigation into what has been told you. That would be a foolish requirement, because you might be deceived in making your investigations. You might have relied in part on your investigations, and

in part on what was said to you. If you relied in any part upon what was said to you, and if you are primarily induced by what was said to you, and these other investigations which you made merely verified such statements, and caused you to rely upon them, then you have not lost your remedy—you can still prosecute for obtaining money under false pretenses; but remember always that you must rely on what is represented to you before you can prosecute criminally. You must not close your eyes to those things which you know to be untrue.

If you have business dealings with a man whom you find to be a liar, no matter what his assets are, no matter what clubs you hold over his head, you had better drop such a customer at once. I am sure that those who have had experience in credit work will corroborate me in this. That, however, is a phase of the subject that is outside the field with which we are dealing. I only mention it incidentally in discussing the question of your reliance on what the other person has told you when you extend money or credit to him.

Silence is Not False Representation

Now, there is another class of cases in which the person deceives himself, or, while he thinks he is acting upon representations or pretenses that are made by the other party to the transaction, does not really do so because the other party merely remains silent. Of course, where it is the duty of one to disclose a fact, and he fails to do it, it constitutes fraud or deceit on his part; but the law leaves those cases to the civil courts, and frequently you have not even a remedy in civil law because of the old rule *caveat emptor*—"let the buyer beware." For instance, if you had a horse in your possession, and I looked at the horse and admired it and asked how much

you wanted for it, and you said $100 and I paid you for the horse and went away with it, I would have no remedy, even if it developed that the horse had many faults, for you made no representations to me whatever. It was my business to make an investigation—to inquire from you, or examine the horse. The law does not attempt in all cases to guard against ignorance or carelessness. It only attempts to guard against those things which you cannot guard against yourself; that is, to guard against the untruthfulness and the misrepresentations of others. It protects you when you use that care and caution which you should use, and the man who would buy a horse without proper precautions in the manner described, could not proceed in any way against the person from whom he bought the horse.

Corroborative Evidence Necessary

There is another thing that I want to discuss before we leave the subject of obtaining money under false pretenses, and that is the evidence by which a false pretense is proved. If a man has done the fraudulent things to which I have called your attention, he is guilty of obtaining money under false pretenses. But the other day in court I went down to hold a preliminary examination in a case where a man had been accused of doing these things. The prosecuting witness testified absolutely to every fact necessary to constitute that crime; and if the prosecuting witness was telling the truth, as I believe he was, there was no doubt that that crime was committed, but I had to dismiss the case at once. Why? Because when I asked him who was present, he had to answer, "No one." Then I asked, "Did you have any written memorandum concerning this transaction?" "No," he replied, "I didn't have anything in writing saying that the defendant had

made these representations." I said, "What other circumstances are there that will corroborate your statement?" "I don't know of any other," was the answer. He was accompanied by an attorney who should have known better. I asked him, "What do you rely on to corroborate this man's statement?" He replied, "We are here to show that the other man is a liar." I said, "You can't do it. You have to corroborate your client's statements before you can make a claim of false representation." So I had to dismiss the case, although the man accused may have been guilty of a crime.

Before you can prosecute a man for making false pretenses, you must either have two witnesses to the transaction; which may be yourself and some one else; or, you must have some representation in writing to corroborate your statement—which is known in law as a false token—or else some other circumstance tending to prove that the misrepresentation was actually made.

Written Evidence

As an instance of written evidence, I go to a money lender and borrow some money on a personal mortgage, or give a mortgage on personal property. I represent to him that I am the sole owner of that property, and that it is free and unencumbered. Usually money lenders put this phrase in their chattel mortgages: "The mortgagor hereby declares that he is the sole owner of the above described personal property, and that it is free and clear of all encumbrances." Right there you have a memorandum corroborating what the mortgagor has said to the mortgagee; and if the representation proves untrue, the mortgagee can prosecute even though no special witnesses were present, because he has the mortgagor's own statement and the memorandum corroborating his statement to prove that the false pretense was made.

Corroborating Circumstances

False pretenses may sometimes be proved by corroborating circumstances, but this method of proof is not frequent, because the man who commits the crime of obtaining money under false pretenses does not, as a rule, do any other corroborative act; he does not allow any other circumstance to be created which will corroborate his victim's testimony, if the victim sees fit to prosecute. It sometimes happens, though, that a man follows a certain course of criminal conduct which enables the prosecutor to introduce corroborating circumstances of sufficient weight to convict him.

Value of Financial Statements

As to the credit man, however, the best thing to do when a man applies to him for credit, is to have him make in writing a statement of what his assets and liabilities are. The important point is not the value of the assets, because that is a matter of opinion which ultimately you will have to determine for yourself, but the statement of fact as to what he actually owns and what he actually owes. What a man owes another is a question of fact; and if I owe you $100, my opinion as to whether it is more or less than $100 will not change the fact that it is $100. The nature of the customer's actual assets, and whether or not they are encumbered, are also questions of fact; and if you get both these statements, you have something that you can use. Banks usually require such a statement from those desiring to borrow money, unless the customer happens to be one with whom they are so well acquainted that they feel it unnecessary to be on their guard.

There is another reason for requiring written statements, besides the fact that they will be legal evidence.

The man who is making a false statement will not put it in writing if he can help it; and if you request him to do so, he will temper it down to the facts, and will not attempt to exaggerate his assets so much and thus you will get at the truth. Business men do not want lawsuits; but they do want good, safe, reliable business. Business that is not safe and reliable, may compel the creditor to resort to the prosecuting attorney's office, or to the employment of private attorneys—a kind of business not often profitable. Of course, a business man should know the law, and should know what to do if he has made a mistake in judgment, and what legal method he can employ to guard against the crook and the dishonest man; but he does not want to get into a lawsuit if there is any proper way by which it can be avoided.

The Defrauded Person Not Always Blameless

Captain Fredericks, District Attorney of Los Angeles, recently prepared some notes on the subject of frauds which I think contain very sound advice for the business man, and are therefore quoted here in part.

"It is very rare indeed that a man is deceived by another, and parts with property, without having a criminal or a civil remedy, unless he, himself, has been endeavoring to get too much the best of the bargain. For instance, no man would pay one hundred dollars for a horse without asking the seller all sorts of questions which, if answered untruthfully, would be the basis of a criminal or civil action, unless he, the purchaser, believed he was getting so much the best of the bargain that he feared to endanger the trade by too much bargaining. In such a case if he gets the worst of the bargain, he is punished by reason of his own avarice and selfishness, and deserves what he gets."

Self-Deception

"Men in business must learn the difference between deceiving themselves and permitting others to deceive them. It is a fact that a man can deceive himself more easily than he can deceive any one else. Many of the cases involving fraud and deceit which get into the civil and criminal courts arise from the fact that the man who has suffered has deceived himself, or has not taken that care or made that inquiry which the law and ordinary prudence require.

"There has been no thought more frequently and thoroughly impressed on my mind in the years I have had intimate knowledge with the sordid side of life than the thought expressed so aptly by Pope,

> 'All is infected that the infected spy,
> As all looks yellow to the jaundiced eye.'

meaning that we often deceive ourselves into seeing what we are looking for, even though it may not exist."

This is just what we must bear in mind in securing business. We must not deceive ourselves into believing that a man is a good customer when he is not.

Prudent and Imprudent Investment

"To illustrate the safe and the unsafe method of procedure in financial matters, I will describe two different methods of investing in an enterprise which is intrinsically good but undeveloped.

"First. The reckless financier will put money and effort into an enterprise although he knows there is no hope of success unless others afterwards buy stock, or put in money, and that, if for any reason this should fail to take place, all that was originally invested would be lost.

"Second. The safe financier agrees to invest his

money only when sufficient capital has been subscribed to fully finance the undertaking, including all possible accidents and incidents. He considers the entire course to be traveled, and all the expenses necessary to be incurred—probably with the aid of experts, and after determining just what capital will be necessary to make all payments and cover all contingencies, he sets that amount as the mark which must be raised before he parts with any of his money.

"Now suppose both these imaginary undertakings fail, and the money invested is lost. Who is to blame for the fact that the first and the second men put their money into the undertakings and lost it? The first man, to begin with, simply gambled on the probability of future happenings, or did not make sufficient investigation to know upon what contingency success depended. Probably no one deceived him. He did not give any one a chance to deceive him. He thought he saw a chance for large rewards, and deceived himself. He is the one who requires the services of a guardian.

"In the second instance, however, the investor has eliminated chances to a large extent; and when the enterprise fails, he is in a position to hold some one civilly or criminally liable—criminally liable if he has relied upon a false statement made to him in his investigation prior to investment, and civilly liable in any other case.

"The first investor comes to the authorities in mad haste, and endeavors to use the criminal law in order to extort his money from some one who would rather pay than be prosecuted. I do not think that he does this always viciously, but as a rule thoughtlessly. He merely wants to get his money back, and is very much disappointed when the district attorney will not prosecute under the circumstances.

"The second investor has not deceived himself, and if his enterprise fails, he has some one upon whom he can rely, or upon whom he did rely, rather; and when he comes to the district attorney he has a case."

And that is the class in which you should always endeavor to be. If, for any reason, you, or the firm or corporation with which you are connected, has been deceived or cheated, let it be not a case of self-deception, not a case of carelessness on your part, but a case where you had to rely and did rely on representations which were knowingly, not thoughtlessly, made to you by the person with whom you were dealing. Then in that case a prosecution can be instituted in the criminal courts, and, if there are any assets at all, you can prosecute successfully a civil action for the recovery of your money.

It is the duty of the district attorney to prosecute criminals, but it is not his duty to run a collection agency. Most men who have committed crime, if they themselves lack the funds, have friends or relatives who are willing to come to the rescue, and put up money to stop a prosecution if the district attorney's office can be used in that way. But remember that this is not the duty of the district attorney; and the ordinary district attorney objects to being used as a collection agency, and will refuse to be so used. When you attempt to compromise a crime, to dismiss a case once instituted, on recovery of your money, you are either compounding a felony or a misdemeanor, or you are guilty of extortion. A man who tries to use the district attorney's office even to collect a just debt is guilty of extortion, and he cannot, when charged with extortion, set up as a defense that the money he was trying to collect was really owing to him. This is something that is not realized by those who attempt to use the district attorney's office in this way, but it is the case nevertheless.

Summary

You must use every effort to protect yourself from fraud; investigate with care, and then use your own best judgment. You should understand the law in order to know when a man who has violated it may be prosecuted, so as to deter him and others from committing like crimes in the future. When you have been cheated or defrauded to the violation of the criminal law, you ought to prosecute relentlessly, even if your prosecution results in some temporary financial loss to yourself. If credit men in general will do this—will let the criminally inclined know that money is no object to them when those with whom they are dealing have violated the law of fraud—the practice of obtaining money or goods under false pretenses will cease very soon, and the district attorney's office will no longer be needed as a collection agency.

CHAPTER XI

AMICABLE ADJUSTMENT WITH INSOLVENT DEBTORS

By F. C. DeLano

Advantages of Amicable Adjustment

The "Amicable Adjustment" is the peaceable, friendly adjustment between debtor and creditors by which the best results for both are obtained, and this without litigation, for litigation is legal warfare, and war is—expense! Its superiority to all other methods is shown, first, in the reduced cost of handling estates; next, in the shorter time involved in settling with the creditors; and last, but not least, in the larger amounts paid to the creditors. Of these three matters we will speak later.

California Boards of Trade

In the matter of amicable adjustments the West has taken a leading part. For many years the wholesale merchants of California have been adjusting their losses and liquidating the estates of insolvent debtors through the medium of adjustment bureaus, the principal ones being the Board of Trade of San Francisco and the Los Angeles Wholesalers Board of Trade. The Board of Trade of San Francisco was organized in 1877, and has a present membership of 218, handling an annual volume of business amounting to more than $700,000. The Los Angeles Wholesalers Board of Trade has a membership

of 135, with receipts and disbursements in 1912 of more than $500,000.

These two organizations are mentioned as prominent examples of the growth of the adjustment idea; and the fact of their continued existence and the steady, unsolicited increase in their membership would seem to be sufficient evidence that the majority of the wholesale merchants of these two cities have realized, and are profiting by, the advantages of the adjustment bureau.

Increase of Adjustment Bureaus

Adjustment bureaus everywhere are growing in numbers and in strength. The larger business centers west of the Rocky Mountains, such as Salt Lake City, Denver, Spokane—and even small towns like San Diego—have adjustment bureaus in successful operation, handling practically 75 per cent of all the business failures. The larger Eastern cities, also, are realizing the importance of co-operation, and are organizing for the purpose of settling cases of insolvency out of court by liquidation or otherwise; though it is safe to say that less than 25 per cent of their failures are settled through the adjustment bureau.

Credit Associations

In the East the various lines of trade have their own associations, taking over and handling adjustments in their own lines of business. Such are the Manufacturing Jewelers Board of Trade of Providence; the Shoe and Leather Board of Trade of Boston; the National Clothiers Association of New York; and the National Jewelers Board of Trade, with headquarters in New York and local secretaries in all the large cities. But the greatest co-operative association of this kind in the busi-

ness world is the National Association of Credit Men, organized about eighteen years ago, and now having a membership of over 16,000, with more than 80 affiliated local branches, and with 45 bureaus for the exchange of credit information and for the adjustment of insolvent estates.

Economy of Adjustments

Now, what is the meaning of all this? It is simply a part of the forward movement, world-wide in extent, to stop economic waste. Great combinations of capital with the latest and most improved machinery, utilizing all the forces of nature, are striving for the maximum of production with the minimum of cost; but it has been left to the credit men of the extreme West to teach the wholesale merchants of the entire nation the art of conserving their credits—their debtor's assets—and of saving to their own commercial houses the greater portion of that waste which has heretofore been eaten up by courts of equity, attorneys' fees, and other useless expenses. All this is accomplished by the amicable adjustment with failed debtors.

Adjustment Procedure

When a debtor fails, you are advised of the fact by the mercantile agencies, by your salesman, or by some other creditor; or perhaps your first notification is when the telephone rings, and you are asked to attend a meeting at the "Board of Trade." Such a meeting, however, does not always mean a failure; for sometimes, when a debtor is given an extension of time and helped along a little by his creditors, he pays them in full and continues to be a good customer, often discounting his bills.

On the other hand, it frequently happens that an

individual who fails to recognize any moral obligation to his fellow creditors, will levy an attachment on a debtor's place of business, place a deputy sheriff in charge, close the store, and not only injure the debtor's trade, but run up a bill of expense that is part of the great waste he should be seeking to avoid. Sometimes, also, a debtor, poorly advised by some attorney who has a higher regard for fees than for the welfare of his client, evades his creditors and procures a coat of whitewash in the bankruptcy court.

Consulting with Creditors

When a man's place of business is attached, or when he is in financial distress, his wisest course is to consult his heaviest creditors. If they are unable to help him over his immediate difficulties, a meeting of creditors should be called at once. Sometimes a meeting is called by a creditor who has heard something of the debtor's troubles, financial or otherwise; sometimes by one who knows nothing of the debtor's difficulties except that he has been unable to collect his own account. These meetings are held at various places, sometimes at the office of the debtor's attorney, occasionally at the debtor's place of business, but generally at the office of some creditor, or at the office of the adjustment bureau.

When a debtor calls a meeting of his creditors, it is almost certain that he has reached the end of his rope, and wishes to place his affairs in their hands, allowing them to adjust them as best they can, and hoping that they will be satisfied to give him a release. Sometimes the debtor demands this release as a consideration for his making an assignment, or a transfer of his assets; sometimes he overlooks this request, and it is granted to him voluntarily by his creditors; and sometimes, yielding to

the demand of certain creditors—a demand not often made—debtors will make an assignment or a transfer of their entire assets, and give their personal note for the deficiency. These notes are usually payable on demand, or at some specified time, without the slightest idea of how or when they can meet these promises.

The Debtor's Attorney

If a meeting is called by the debtor's attorney, there are several things to be considered. The attorney has generally gone over the debtor's affairs very carefully, and being fully advised as to his client's condition, will now ask that he be granted an extension of time in which to meet his obligations; or will suggest a composition settlement at so much on the dollar, ranging anywhere from 25 to 50 per cent; or will state that the debtor cannot continue the business, and is willing to transfer everything to the creditors, providing they will release him from all obligations. In this last case he generally insists on the further provision that the debtor be allowed to retain such of his personal or real property as may be exempt from execution or subject to homestead rights.

Unscrupulous Debtors and Attorneys

I am here speaking only of reputable attorneys. But sometimes we have to deal with a crooked debtor or a more crooked attorney—more crooked because he is more experienced and more able—and in such a case the creditors will often accept the proposition outlined by the attorney, even though it may be very unsatisfactory to them. They do this because they know, or at least they fear, that the attorney has carefully planned to prevent their obtaining any more under bankruptcy than the debtor is offering through this settlement.

But the best laid plans of crooks and their attorneys may sometimes fail. For instance, we had a case in a neighboring town some two years ago which had all the appearance of being a carefully planned fraud. We will say that the party's name was Brown. The business had been conducted in the name of "A. Brown" for a great many years; and it was generally understood that "A. Brown" meant Adam Brown; but as a matter of fact, it meant Anna Brown. In addition to the business, Mrs. Anna Brown owned considerable real estate, good property, and was responsible in every way. The business, however, got into a shaky condition and Mrs. Anna Brown, with the aid of a certain attorney of Los Angeles, conceived the idea of incorporating it. She transferred her stock of merchandise for the full amount of the capital stock of the corporation, and then, in addition, took a note for $25,000 for the "good-will" of the business, and afterward transferred her stock to Adam Brown, who had no property. Had the concern gone into bankruptcy six months afterwards, Mrs. Brown would have been the largest creditor; but the real facts were by accident discovered sooner, and, instead of collecting from the bankrupt concern, Mrs. Brown was compelled to give a trust deed on about $20,000 of real estate to meet its liabilities. This broke up the combination.

The Creditors' Meeting

Nearly all the adjustment bureaus now maintain credit departments where may be found reports on hundreds or thousands of debtors who are slow pay, or who are not in the habit of discounting. From these reports, if the debtor's name is included, a fairly accurate list of the various wholesale houses that he is owing may be obtained. If no such report is available, and if the

creditor asking for the meeting has no list of creditors, he will secure a partial list by telephone and invite all the local creditors known to him to attend a meeting. If it is possible, the debtor will also be requested to attend.

Methods of Settlement

Generally speaking, only four methods of settlement are possible: extension of time, with or without security; composition settlement; assignment, with or without release; and bankruptcy, voluntary or involuntary.

Information Required

It is necessary, of course, before settling with a debtor, that his creditors should obtain as full and complete information regarding his affairs as possible. The first question they will ask is, "How much do you owe?" Next, they will want to know the amount of assets in detail, the value of fixtures, whether the fixtures are owned or leased, clear or mortgaged, or being purchased on conditional sales contract; and finally the amount of cash on hand or in the bank.

You will invariably find the cash on hand to be the only asset that will not shrink in value before you get through—just the real hard cash in the cash drawer or in the bank. And even the cash in bank will not be worth one hundred cents on the dollar if the bank holds a note that is due (and most bank notes are due in a crisis like this), for the law gives this creditor, the bank, the right to seize the debtor's money on deposit and apply it on his note.

Then the creditors will ask for the amount of the book accounts that are good, the value of wagons, horses, and other live stock, the amount of insurance carried, the amount of business the debtor has been doing for the

past month or year, the margin of profit he is making, and so on. Then they will want to know the ratio between his gross profit and his expense, and from these figures they will judge the probability of his paying in full if allowed to continue in business.

The Business Doctor

The debtor may need the services of an expert in some particular line—a man who would now be called a "business doctor" or an "efficiency expert." I know one man who well deserves this title, for he can detect the wastes and leaks in the ordinary retail business with such accuracy that he can reorganize the entire system, and, if conditions are normal, put the business upon a sound basis so that soon it will show a steady and healthy profit. There are many men in need of the services of a good business doctor, and the latter, if he is allowed to prescribe in the early stages of trouble, will treat his patient with pills that are nicely sugar coated; but if the patient delays too long, his medicine is likely to be very bitter, and he may in the end furnish another job for the commercial undertaker.

I can probably best illustrate this point by the case of a certain grocer who got into trouble. We will call him John Blank. A meeting of creditors was called, and the debtor requested an extension. This was refused at the time by the creditors, but an assignment was taken and the business was continued with a competent man in charge. The debtor had been in business six years, having lost during that time some $12,000. He had averaged nearly $200 per month loss. Starting with $6,000 in cash of his own money, he had become embarrassed, and then an uncle had advanced him as much more. Now it was all gone. In ten or twelve weeks, however, the

new manager stopped some of the losses, changed the system, and made some $995 profit. The creditors then settled with the debtor at 75 cents on the dollar. The debtor had learned how to stop the waste in his own business, and he still continues with apparent success.

Details of Adjustment

When the creditors have finished their examination of the debtor, they will excuse him from the room, while they discuss his affairs in private; and if the debtor is not suspected of fraud, they will consent to his making a transfer of the assets, and will relieve him of his obligations. They then appoint a chairman of the meeting, and generally delegate to a committee of the larger creditors full power to negotiate with the debtor for the assignment, or for an extension, or for a composition settlement —whichever is deemed best.

If it is to be an assignment, the papers are generally signed at once, and a representative of the creditors accustomed to such work is sent to take possession of the store and all other assets, to take an inventory, to collect the accounts, see that the place is kept insured, and in every other way protect the business as if it were his own. Then the report of the adjuster, or man in charge of the business, is presented to the creditors' committee, and the assignee, receiving his instructions from the committee, proceeds to conduct the business, or to settle it, or to close it up, or to move the business into a warehouse, or to dispose of it in such other way as directed by the creditors' committee.

The creditors' committee is generally composed of the three largest creditors—those who will suffer most if there is any loss; therefore, the smaller creditors, knowing these conditions, can generally feel that their interests

are well protected, because the larger creditors will surely look out for their own.

Continuing the Business

If the creditors' committee decides to continue the business as a going concern, it will be necessary to purchase goods and do all the other things required to run the business. If goods are to be purchased in the name of the assignee, the buying should be confined to those houses which are already interested, but only on the condition that the prices, delivery, and quality of the goods are equal to those which may be obtained elsewhere. This should be watched very carefully, for I have often known creditors to raise the price of their wares as soon as they felt that the assignee was compelled to purchase his goods from them.

Selling the Business

If the business is to be sold as a going concern, or is to be closed immediately and sold after inventory, the sale may be conducted in several different ways; sometimes even by the professional auctioneer, although we have never had very much success with this. Sometimes the assignee holds a public sale—or we might term it a private auction—to which he invites all professional buyers and others who may be in any way interested, or are likely to buy. Public notice is generally given through the classified advertising in the daily newspapers under the head of "Business Chances" or "Auction." Sometimes these sales are handled exclusively over the telephone, or by the adjuster in charge, the different offers or bids made by the buyers being submitted by the assignee to the creditors' committee for its approval.

Generally the assignee demands cash payment on the

sale of the assets, but occasionally he will be instructed by the committee to accept the note of the buyer. This is rarely done, however, for the reason that the creditors have already been without the use of the money represented by their interest in this estate for a long time; and they are usually eager to have the assets converted into cash. Of course they are entitled to this; but it is often hard to find a buyer who is able or willing to give as much as the committee believes the merchandise is worth, and it may be necessary to give him some time in which to raise the full amount of the purchase price. Whenever this is done, the purchaser should give security, or a guaranty of some kind, to the creditors.

Preliminaries of Adjustment

The adjuster in charge of the case, first sends to the assignee a full list of the creditors; then he takes a complete inventory, and cleans up the stock and the entire store. He gives the assignee a list of all the accounts receivable, making such collections as are possible while in charge of the store, and assures all small or local creditors that the assignment is for the mutual benefit of all the creditors, trying to persuade them not to attach by advising them that such an act would increase the expense and materially lessen their recoveries—for bankruptcy will most likely follow if any creditor attempts to force a settlement of his claim in any manner by which he obtains a preference at the expense of the others.

Creditors Must Cooperate

We had a case only last week where a man who was in debt about $1,600, with assets of about $1,800, made an assignment for the benefit of creditors. Two small creditors, having claims aggregating less than $100,

attached. They were frank to say that they believed that the other creditors would allow them to be paid in full, and tried to bluff it out; but it did not work that way. The creditors held a meeting, called the debtor in, and showed him the injustice of paying two small creditors in full and leaving the larger ones to take what was left. Then they persuaded him to prepare a voluntary petition in bankruptcy. This petition would have been put through, had not the creditors who had attached seen their mistake and consented to the assignment.

Shrinkage of Accounts Receivable

And now a word about the book accounts which I have mentioned. Our records, extending over a number of years, show that the accounts receivable of the average retail dealer are not worth 60 cents on the dollar. I believe our records for the past year show that we collected only 56 cents and a fraction. The ordinary retail dealer sometimes carries old and worthless accounts as live assets. I know of a case where a certain corporation had been selling to Mexican laborers and Indians on credit. In a recent attempt to collect these accounts, we found that many of the debtors had drifted away; quite a number had been dead for some time; and one or two were in the penitentiary; and yet all those accounts were carried as live assets. The president of the corporation was fooling himself as much as he was his creditors.

Many a retailer does not know the full name or address of a large number of his regular customers. He relies on his delivery clerk, who, after the failure, is too busy hunting for another job to assist the adjuster, or, as often happens, is immediately employed by a competitor, who hopes to secure all this new trade, and of course will give no assistance to the assignee.

Discounting the Debtor's Statements

If the debtor is asking for an extension, the creditors should invariably take an inventory and thoroughly investigate the situation before granting or refusing the extension. When a debtor asks for an extension he will tell you he has a certain amount of merchandise and fixtures, and that he has so many thousand dollars' worth of bills receivable that are good—in fact, he has everything but money—and he will make almost any kind of a promise if only the creditors will allow him to continue. I have heard debtors who had only a small retail business make promises that many a wholesale business would hesitate to make.

But if, on the other hand, the debtor wishes to settle with his creditors for 50 cents on the dollar, or any other amount, everything assumes a darker hue. The merchandise is shop worn, out of style; the stock is broken; the accounts are old and uncollectible; the fixtures are mortgaged or on lease contract. In fact, it would seem that the creditors must have forgotten all about this man, otherwise he never would have been allowed to continue.

Now, when an inventory is taken it will generally show that the man who has asked for the extension, has inflated the amount, or at least the value and condition, of all his assets; while the other man has depreciated them, knowing that a much better settlement can be obtained if the assets are small. If a disinterested party makes an investigation, his report will show the conditions in their true light; and it is on this report, rather than upon the debtor's statement, that the creditors should base their action.

Procedure when Extension is Granted

When the creditors think the debtor is entitled to an

extension, some sort of an agreement should be entered into which will not only bind the debtor to perform certain duties, but will also prevent the creditors themselves from taking advantage of each other or of the debtor, so long as he makes the promised payments. We have found it more effective, and I may say simpler, where an extension is granted, to allow the debtor to give his note for the amount of the indebtedness. The person to whom the note is made payable then obtains the assignment to himself of the claims of all the creditors. This so changes the situation that the debtor has but one creditor —the man to whom he has given his note for $5,000 or $10,000, or whatever the amount may be; and the creditors, having assigned their claims to the holder of this note, are no longer able to molest the debtor, as they have no claims against him.

Protecting the Creditors

The one creditor holding the note—who is, in fact, a trustee for all the creditors—should be in a position at any time to demand the payment of his note if the debtor becomes delinquent in his payments, or if anything happens to the debtor which in any way imperils the interests of the creditors. The form of note used in such cases provides that the note shall immediately become due and payable if any of the instalments or interest thereon be not paid when due; or upon any attachment or other process of court, or any other action or proceedings against the maker of the note; or any notice of intention to sell, or of any sale of the stock in bulk. These provisions are very necessary to protect the interests of the creditors.

Protecting the Debtor

At the time this settlement is agreed on, it is scarcely

possible that the creditors, or even the debtor himself, will be able to state accurately the exact amount of his indebtedness; we find it convenient, therefore, and often of considerable advantage to draw the note for more than the amount the debtor thinks he owes; but, for the protection of the debtor, we give him a contract or agreement providing that the holder of the note, who is also the assignee of the claims of all the creditors, shall credit upon this note the difference between the amount of claims actually assigned and the face of the note. This is a protection to the creditors themselves, and to their assignee, and is fair to the debtor.

Providing for Contingencies

The older credit men will at once recognize the wisdom of providing for the various contingencies I have mentioned. If a debtor is inclined to be tricky, or is poorly advised, or of his own volition shall decide that the best thing to do is to save what he can from the wreck, then, if the ordinary note has been taken instead of one with these provisions, the debtor can make a few weekly or monthly payments to the holder of the note, and immediately thereafter sell out, or file a notice of intention to sell, and dispose of his business. He might be able to sell for cash, with which he could purchase real estate, file a homestead, buy building and loan stock, or in any one of a dozen different ways succeed in placing the proceeds of the business beyond the reach of his creditors.

Investigate Before Settlement

The foregoing applies to extensions. If the debtor asks for a settlement at 50 cents on the dollar, or at any other percentage of his liabilities, he should be compelled

to pay more than could be realized through bankruptcy, for the advantages to him are so great that even though he cannot raise the full amount of his settlement in cash, he should make up the difference later. But the debtor's proposition to settle should not be hastily accepted. Attempted deception is common under such circumstances. Sometimes fraud can be proved, but we have seen too many cases where we felt morally certain that the debtor had carefully planned for this settlement months in advance, and yet, not having the proof of our convictions, nor any way of obtaining such evidence, have been compelled to accept a settlement which we knew was a rank injustice.

We have hundreds of cases coming into our office every year, and no two are exactly alike. I have in mind one particular settlement where the debtor was believed to have gradually withdrawn funds from the business, placing them in the care of a relative or friend in Sacramento, or some distant town. These funds were withdrawn so gradually that the business did not appear to suffer. When the time came he borrowed this amount, the accumulation of his savings, from his friend in Sacramento, giving him a note, and then he paid one certain creditor, preferring him. Soon after, it was found that he was insolvent, and he made a settlement with his creditors at 40 cents on the dollar. He had no difficulty in preparing the evidence to corroborate his statements as to the amounts he had borrowed; but I am convinced now beyond a shadow of a doubt that the money borrowed was his own money. Nevertheless, so carefully had he arranged matters that it would have been very difficult, if not impossible, to prove in bankruptcy proceedings that a fraud had been committed. Therefore, on the evidence, the creditors' committee believed they were justified in

recommending this man's offer of settlement for acceptance. Six months afterward, he came into my office and said he was in a position to finance any small dealer who needed ready cash to settle with his creditors; in other words, he was now a financier!

Consent of Creditors

One of the most important and most difficult tasks of the assignee or the creditors' committee is to obtain the consent of the creditors to the plan of settlement. This is done in various ways. The creditors are notified that a meeting has been held, and they are advised as to whatever action has been decided on. The amount of assets and liabilities are stated, as well as the causes leading up to the failure or whatever it may be. Original agreements are circulated for the signatures of the creditors, with a letter of explanation, or, if it is impracticable to circulate original agreements, then the facts and figures are given in a letter, with the recommendations of the committee, which asks for written authority to sign the name of the creditor to the original agreement.

Creditors Must Wait for Their Money

Now, whether the case be that of an assignment, an extension, or a composition settlement, the creditors want their money as soon as they can get it, and some of them become very impatient because the distribution is not made forthwith. This may be done if the assignee, or the person through whom the settlement is conducted, is absolutely sure that all creditors have consented to the settlement, or have agreed to the assignment. But the assignee cannot be positive; and it frequently happens some two or three months after a settlement has been made, or an extension granted, or the assets have been

sold under an assignment, that some unheard-of creditor appears. He may be a local creditor who has neglected his collections, or he may be an Eastern creditor who, depending upon his salesman's reports, has not yet received a report on this particular customer. Thus, for the protection of the debtor, as well as for his own protection and that of the committee, the assignee should hold the entire proceeds of the assignment at least four months after the date of the transfer, because this transfer might become invalid and be set aside if within that time the debtor should file a voluntary petition in bankruptcy, or if certain creditors, having a personal spite or grudge against the debtor, should insist on payment in full. This often happens when the debtor fails just after receiving his first shipment from one or more firms, or when distant creditors—and sometimes local ones as well—instead of investigating the situation carefully for themselves, file their claims with their own attorney. He, unfortunately, often sees but one thing, namely, the fees which he, the attorney, is to make out of this particular collection. Now, this attorney may believe that he can play the "dog in the manger" act, and will hold up a settlement unless he receives payment in full for his client. Sometimes he carries this too far, and the other creditors deliberately file an involuntary petition in bankruptcy to compel this "dog in the manger" to prorate with the others, even though they know it is costing them many dollars.

Again, if the assignee distributes the money at once, and an unfriendly trustee in bankruptcy is elected, he may demand an accounting from the assignee, who has retained nothing; and this will be very embarrassing, for you can well imagine the difficulty of collecting the money paid to far-distant creditors. This is why all funds in

assignment cases are held for four months, to protect the assignee as well as the debtor.

Distribution of Dividends

In cases of assignment the first dividend should be distributed immediately after the four months have expired, and other dividends should follow as rapidly as funds accumulate sufficient to make a dividend worth while. In cases of extension, dividends should be distributed as often as payments are made by debtor, unless such payments are so small as to make the dividend insignificant; but a dividend should always be declared, if all creditors have agreed to the settlement, as soon as there is sufficient for a 10 per cent payment.

Difficulty with Foreign Creditors

In composition settlements, the local creditors, who are familiar with the situation, generally sign the agreement without much delay, but foreign creditors—those who are some distance away from the scene of action—view the situation so differently that they always cause more or less trouble. About two-thirds of the foreign creditors will consent to the settlement if it is recommended by the local creditors. The other third will fail to answer letters, or will state that their claims have been forwarded to attorneys, or that they want a greater percentage paid on their claims, or that they want a preference. Their wants are so many, and their indifference to your letters so great, that an immediate settlement or an immediate distribution is often impossible; and then comes trouble from those who have already consented. They argue that, having consented to the settlement, they should receive their pro rata at once—overlooking the fact that a settlement is rarely possible unless all creditors give their consent to the same action.

Recently we had in process of settlement an estate where the principal creditors—the three creditors who formed the creditors' committee, having among themselves about $12,000 of liabilities—had accepted and strongly recommended a settlement at 50 cents on the dollar; but this settlement could only be brought about by taking secured notes payable at $400 a month, the security being a ranch, a residence property, and apartment houses. All the creditors but one consented. This man was in Chicago, and letters and telegrams were sent to him repeatedly without effect. Finally, in response to a more urgent telegram than usual, he wired back that he would take 50 cents on the dollar provided Chicago exchange were placed in his hands before the 19th instant. This gave us five days to collect!

Attachments Sometimes Necessary

I have undertaken to tell you the advantages of a friendly settlement over attachment or bankruptcy, but very often attachments are necessary to bring about a friendly settlement. Sometimes the sheriff is placed in charge of a man's business to protect him from some individual creditor, or to protect some creditor as against other creditors—for we find that creditors fear each other fully as much as they do the debtor. Attachments are necessary at times when some creditor has become impatient, and has demanded and received a chattel mortgage as security on some past-due indebtedness, thus obtaining a preference; or when a debtor has disappeared; or when, after a place has been destroyed by fire, the debtor for some reason declines to turn his insurance over to the creditors. But such attachments should be for the benefit of all creditors.

Sometimes a debtor is recklessly extravagant, and

appears to be dissipating his own assets. Sometimes he has transferred a portion of his assets, or is suspected of having committed some act that would be a fraud upon his creditors. Then an attachment must be made to create an act of bankruptcy, for in such cases bankruptcy is necessary unless the debtor, after having been attached, willingly consents to a peaceable settlement without further litigation. Bankruptcy is necessary also when the debtor has conveyed his assets with intent to hinder, delay, or defraud any creditor, or, as just stated, when he has given a chattel mortgage for the purpose of preferring some one creditor over the others; or when some creditor having been poorly advised by his attorney, has attached the greater portion of the debtor's assets, believing that his attachment will hold good in spite of bankruptcy, and that he will receive his pay in full.

Debtor Should be Released

In nearly all cases of assignment, the debtor believes that he is being fully released from all his obligations; and where the failure is an honest failure, and there is no immediate prospect of the debtor's recovering his financial stability, this release should be given to him by his creditors.

I have known of very few cases where, an assignment having been made and no release given to the debtor, the latter voluntarily came in afterwards to pay off the balance of the indebtedness. The only case I now recall is that of two brothers, Italians, who had been unsuccessfully conducting a cigar stand. They made an assignment for the benefit of creditors, without asking for a release. There was a deficiency, as there generally is in such cases; and one day, about six months later, the younger brother came into the office and wanted to know how the settle-

ment came out. When advised of the amount that was still owing, he produced the cash and paid off the entire balance. And how do you suppose he obtained this cash? He was working in a ditch, digging sewers at $1.75 a day. This is the one exception to the general rule, in my personal experience.

Comparative Costs of Settlement and Bankruptcy

The advantages of the friendly settlement as to the matter of cost may best be realized by comparison. For example, take a case in bankruptcy where the total assets of the estate will amount to about $20,000, more or less, and, after the most careful administration by a competent trustee, he has for distribution, we will say, $10,000 in actual cash. We will assume that there are one hundred creditors. The expenses of administering this estate by the trustee, or through the bankruptcy court, would range from $700—which is the lowest possible amount that we can imagine—up to $1,600 or even $2,000, while an assignee would not, or should not, receive more than $750, and the probabilities are that his fees would be much less than that amount, the maximum being $920 and the minimum $320. The difference is perceptible, to say the least.

As regards bankruptcy, the annual report of the San Francisco Board of Trade shows that in the year 1912 the distribution under bankruptcy to the creditors in all cases handled by them was 21 9/10 per cent as against 55 3/10 per cent in case of assignment. The reports of the Los Angeles Wholesalers Board of Trade for 1911 show 37 4/10 per cent dividends under bankruptcy as against 57 8/10 per cent under assignments, and in the year 1912 the ratio is about the same. And further, the Attorney General's report for 1912 shows the average

expense of administration to be 29 7/10 per cent of the assets realized, while in California alone the expense was 33 per cent.

Saving of Time

Now, as to the saving of time that can be made through this friendly settlement. I would like to cite a special case that came to my notice not long ago where a friendly settlement was made with a certain debtor about forty or fifty miles away, who proposed to pay his creditors as fast as the cash came over the counter, or as his collections were made. He even offered, if the creditors preferred, to turn over all his daily receipts to a friend, and let the friend remit to the creditors. But the reputation of this particular debtor was not of the best, and the creditors therefore hesitated about trusting his friend, for, although the latter was responsible and of unquestionable integrity, he was nevertheless a friend of the debtor, which was enough to condemn him. The creditors therefore told the friend, who acted as mediator in this settlement, that they would sell their claims at a discount of 10 per cent. This proposition was accepted, and the creditors received their money in weekly instalments. While they did not receive 100 cents on the dollar, it is very doubtful whether they would have received any greater amount through debtor's own manipulation of his funds, and certainly not as much in bankruptcy. Without the medium of some adjustment bureau, and in the absence of some one who could devote the necessary time to handling a matter of this kind, some creditor would probably have attached this debtor, and this would have resulted in bankruptcy, or else that one creditor would have secured a full settlement of his claim, while the others would have been left out in the cold.

Extensions Generally Successful

As to the results that are obtained through settlement outside the courts, it may be safe to say that nearly all composition settlements will produce greater dividends than bankruptcy, the exceptions being where the debtor is dishonest. In case of extension the creditors will in most cases receive 100 cents on the dollar. My observation has been that about two-thirds of the extensions are successful; and in such cases the creditors receive their pay in full and the debtor is able to continue; but in about one-third of these cases the debtor is so crippled by the payments that he makes or attempts to make, that before he has completed them he is compelled to liquidate either through an assignment or through bankruptcy. But even though he cannot carry his payments to completion, the creditors in most cases have received a greater amount than they could have recovered had they attached, or had the debtor filed a voluntary petition in the beginning.

Advantages of Settlement for the Debtor

I have been trying to show you some of the advantages of the friendly settlement, but only from the standpoint of the creditor. The debtor, however, is protected and benefited by this mode of settlement fully as much as the creditor. If there were no adjustment bureaus or friendly adjustments, nearly every unsuccessful merchant would be attached or thrown into bankruptcy, as I understand is still the case in the East; and by some of his creditors, at least, he would be branded as a crook, simply because they had lost money in their dealings with him.

We find that this point of view is very often taken. At a meeting of creditors, some disgruntled individual, who has perhaps neglected to exercise the ordinary pre-

cautions, will say, "Well, the man's a crook; let's get after him and prosecute him for fraud." But it does not necessarily follow, because a man owes you a debt and is prevented by incompetency or by some of your competitors from paying you the full amount of your claim, that he is dishonest. His intentions may be as honorable as yours. His business may not be as prosperous as some, but it is furnishing him with a livelihood; he buys many of your goods and pays for them after a fashion. He may be slow at times, it is true, but there is no prospect of loss until something out of the usual happens, and, even when this something happens, the debtor may obtain an extension; he may pay out in full; and he may continue to buy many thousands of dollars' worth of supplies from you; moreover, having learned his lesson, he may discount his bills.

There are many such cases; for the debtor, during his period of extension, is generally compelled to buy for cash, and, if he wins out, he has learned that the item of discount amounts to a considerable sum of money; and then, too, he has acquired the habit of discounting. If a man is insolvent and makes an equitable settlement with his creditors, he generally makes good; and the creditors who lost 25 or 30 per cent, or even a greater amount, in their former settlement with him, now consider him a safer credit risk than before, for by this settlement with his creditors he has wiped out a considerable portion of his debts without diminishing his assets. They now know his exact condition, whereas before they merely thought they did. The man has paid his debt in full so far as he is able; in fact, he has paid his creditors generally a great deal more than they would have received in bankruptcy; and he has avoided the stigma generally considered to be attached to the bankrupt.

Adjustment Means Cooperation

Californians will all remember the failure of the melon growers industry in the early days, and how by cooperation they were able, through the Melon Growers Association, to raise melons and ship them with profit instead of having only red ink returns. You may have heard also of the Orange and Lemon Growers Associations. Now, what these various associations are to those particular industries, the Adjustment Bureau is to the credit man. The Adjustment Bureau is simply cooperation among creditors or credit men. The Los Angeles Wholesalers Board of Trade is only the machinery by which the wishes of creditors are carried out. Cooperation among creditors is our work, and should be the work of every merchant. If you remember this, you will more nearly realize what the National Association of Credit Men is trying to accomplish by having adjustment bureaus connected with its local branches in all the large cities.

Cooperation Pays

Generally speaking, bankruptcy cases cost about 10 to 20 per cent of your claims. If you have a claim against a bankrupt of some thousands of dollars, and you receive, we will say, 30 cents on the dollar, in bankruptcy, it is safe to conclude that in the majority of cases you would have received 40 to 45 per cent had the claims been administered by some assignee, some creditor appointed for the parties, a creditors' committee, or an adjustment bureau.

We had a case some years ago where in bankruptcy we could not hope to realize more than 60 cents on the dollar, and this particular debtor was extremely anxious to go into bankruptcy. Some of his larger creditors labored with him for three days or more, trying to get him

to accept an extension rather than go into bankruptcy. At last they succeeded, and, putting an efficiency manager in charge, with the debtor working under his direction on a salary, they continued doing business; and paid 100 cents on the dollar. When the debtor had completed his payments, he made a statement to the mercantile agencies which showed that he had some $6,000 greater surplus than the surplus he showed on paper when he made the assignment. This is one instance. There are others that have worked out differently, but many cases can be made to pay out the same way.

CHAPTER XII

BANKRUPTCY

By W. T. Craig

History of the Bankruptcy Law

Among modern nations, the English have the most perfect system of bankruptcy law, and our system is borrowed largely from theirs. The English system dates from the time of Henry VIII. In those days the merchant sent out his ships, simply praying that they might reach their destination and return safely. If either or both of these things failed to happen, he was very likely unable to meet his obligations to his creditors and became a bankrupt. His creditors, however, did not have much consideration for him on account of his misfortunes. The laws did not provide that he should have the right to petition himself into bankruptcy and be relieved of his debts; they simply provided that, under those circumstances, his creditors might throw him into bankruptcy and divide what he had. He had to pay the balance as best he could, and, if he did not pay it, he went to jail.

That conception of bankruptcy continued down to a comparatively recent time. Only during the last century has the modern idea arisen that the bankruptcy law is as much for the benefit of the debtor as the creditor. Its purpose is not only to distribute the bankrupt's assets pro rata among the creditors, but to take from a man the load of debt which makes him a drone, and allow him again to enter society, and possibly retrieve his fortunes.

Moral Obligations of Bankrupts

The idea that bankruptcy relieves a man of his debts is, unfortunately, an idea commonly entertained even by bankrupts themselves. It does not; but, like the statute of limitations, it relieves him of the possibility of a creditor's collecting the debt, although we do not regard a man who will not pay a debt because it is outlawed, as a man of high moral character. The moral obligation to pay debts exists just the same after a man has been discharged in bankruptcy as before; and I am glad to say that many a man does pay his debts, even after he has been so discharged. Such a man is thereafter established in the community as entitled to credit above men of equal financial standing; for the question of integrity is perhaps more worthy of consideration by a credit man than the question of financial standing. The increasing weight given to integrity in credit considerations is significant.

Bankruptcy Law Definitely Established

There is always a certain agitation for the repeal of the national bankruptcy act; and not long ago there was a debate between two universities in which the question of the evening was: "Resolved, that the bankruptcy law should be repealed." But I do not believe it is a very vital question any more. I will not assert that whatever is, is right; but it is safe to say that when a great majority of men definitely agree upon one thing, the dissenters are wrong; and practically every civilized nation in the world, except China, has a bankruptcy statute. In 1900 Japan passed a bankruptcy law which provides that a man must pay his debts, and, if he does not, his creditors may take all that the family has; and, if that is not enough, then the law provides that he shall not be allowed to vote any more.

Voluntary and Involuntary Bankruptcy

Bankruptcy is of two kinds, voluntary and involuntary. Voluntary bankruptcy is open to any one. A debtor, whether he owes one dollar or a million dollars, may file a petition in the United States District Court to be declared a bankrupt; and he will be accommodated. All classes of corporations except four may go into voluntary bankruptcy. The four are banking, insurance, railway, and municipal corporations; they may neither go into bankruptcy voluntarily, nor be forced into it. All other corporations may come under the bankrupt law by either method.

The four classes of corporations that I have named may not be thrown into bankruptcy for good reasons. The banking corporations are usually governed by banking laws which do not permit bankruptcy. The state law governs the state bank, and the national law governs the national bank. It would, of course, be obviously improper to throw a municipal corporation into bankruptcy; and the railways are of such interstate importance that it would not be expedient to allow them to be thrown into bankruptcy. The same reasoning applies to insurance corporations.

Before you can throw a person into involuntary bankruptcy many conditions must be met, and a credit man in giving credit either to a corporation or to an individual, must take into account the fact that if the debt is not paid, he may have considerable difficulty in getting that corporation or person into bankruptcy so that he may get his share of the assets. For instance, no wage earner, and no person engaged chiefly in the tillage of the soil, can be thrown into bankruptcy at all. A wage earner is defined as a person who works for wages, salary, or hire for a compensation of not more than $1,500 a year. A

man, therefore, who earns a salary of $150 a month, would not be considered a wage earner. A person engaged chiefly in the tillage of the soil is, of course, a farmer.

Preliminaries to Bankruptcy Proceedings

Before any one can be thrown into bankruptcy, it must be alleged and proved that he has debts to the amount of at least $1,000, so that a person who owes less than $1,000 cannot be forced into bankruptcy, though he may be a voluntary bankrupt. And before a person may be thrown into bankruptcy, he must be insolvent.

Now, the definition of insolvency, under the bankruptcy statute, is peculiar, and has great significance to credit men. A person is insolvent within the meaning of the bankruptcy law when the aggregate of his property, exclusive of any property that he has conveyed, transferred, concealed, or removed, or permitted to be concealed or removed, with intent to hinder, delay, or defraud his creditors, is not, at a fair valuation, sufficient in amount to pay his debts.

This is an innocent looking definition, but it frequently deters the credit man from getting his debtor into bankruptcy. A person whose entire property, at a fair valuation, exceeds his debts, cannot be thrown into bankruptcy. In the state of California, a man may have a homestead worth $5,000, which is exempt; he may have household furniture, which is also exempt, and there are many other exemptions. He is entitled to have all of this exempt property valued as a part of his assets if he defends a petition in bankruptcy. He may owe $2,000 or $3,000, and it may equal his entire merchandise or business assets; but you cannot throw him into bankruptcy, because this indebtedness is offset by the value of his home, his furni-

ture, and other exempt property. This is something that credit men must always consider before granting credit.

Furthermore, the debtor must be a resident of the judicial district in which the bankruptcy petition is filed, for the greater part of six months, which means more than three months.

"Acts of Bankruptcy"

Let us suppose that all these conditions exist. It is then further necessary that the debtor have committed what is called in the statute as "an act of bankruptcy." He must have done certain things, in addition to being actually insolvent. I know men who are absolutely bankrupt; they owe debts of large amounts; and yet they cannot be thrown into bankruptcy, because they have not done one of those things called "an act of bankruptcy" by the statute. Those acts of bankruptcy are five in number and are as follows:

First. Having conveyed, transferred, concealed, or removed, or permitted to be concealed or removed, any part of his property with intent to hinder, delay, or defraud his creditors or any of them.

Second. Having transferred, while insolvent, any portion of his property to one or more of his creditors with intent to prefer such creditors over his other creditors.

Third. Having suffered or permitted, while insolvent, any creditor to obtain a preference through legal proceedings, and not having, at least five days before a sale or final disposition of any property affected by such preference, vacated or discharged such preference.

Fourth. Having made a general assignment for the benefit of his creditors, or, being insolvent, having applied for a receiver or trustee for his property, or where,

because of insolvency, a receiver or trustee has been put in charge of his property under the laws of a state, of a territory, or of the United States.

Fifth. Has admitted in writing his inability to pay his debts and his willingness to be adjudged a bankrupt on that ground.

In short, a bankrupt must have transferred some of his property to a favored creditor, or concealed it, or have been sued and a judgment obtained against him, and his property be about to be sold under execution; or he must have made an assignment for the benefit of his creditors, or admitted in writing his inability to pay his debts, and given his written consent to be adjudged a bankrupt on that ground. If he has not done one of these things, no one can throw him into bankruptcy.

To meet this condition, it is frequently necessary to create an act of bankruptcy. For this purpose certain creditors will sometimes bring suit, obtain a judgment, and levy an execution, and then other creditors use the condition so created as ground for throwing the debtor into bankruptcy. You can see that, if the bankrupt is attempting to pay favored creditors, or endeavoring to keep out of bankruptcy in order that certain of his acts may not be inquired into, he is going to be very careful that one of those "acts of bankruptcy" cannot be successfully alleged against him.

The Bankruptcy Law

The national bankruptcy law, I believe, is going to be a part of the commercial organization of the nation. The present statute will probably be amended to suit changing conditions, as has been repeatedly the case in England, and the statute is likely to be more and more considered in commercial transactions, because the giving of credit is

going to be placed upon a more scientific basis. The National Association of Credit Men is seeking to accomplish this object. It is opposed to the repeal of the statute, which it considers a necessary adjunct to the perfecting of the science of credit.

Delays in Bankruptcy Proceedings

The prejudice against the bankruptcy law—that is, the earlier laws—was caused by the enormous expense and delay attendant upon the execution of the law, and it must be admitted that under the law of 1867, which was repealed in 1878, the expenses and delays were certainly inexcusable. But no such conditions exist under the present statute; and, if there is any reason to believe that in any given case things are mismanaged, it is the fault of the credit men, because the credit men now rule.

Expense of Bankruptcy Proceedings

Nor is the expense of bankruptcy great. The fees provided by the statute are very small. Take, for instance, the trustee—the man who is elected by the creditors to take over the assets of the bankrupt and to convert them into money and distribute them. Upon him rests the administration of the entire estate; and, no matter what he may have done, or what time he may have given to its administration, his fees are fixed by the law itself; and you will admit that they are very small indeed: 6 per cent on the first $500; 4 per cent from that to $1,500; 2 per cent from $1,500 to $10,000, and 1 per cent on all above $10,000. Where the business of a bankrupt is conducted by the trustee, these fees may be doubled. Now, because this compensation is so small, there is very little opposition to the election of a trustee in the bankruptcy courts. It is only in very large cases that

any one wants the office at all. The contest for the election of trustee, if there is any contest in an ordinary case, does not originate in the fact that some one wants to be trustee to get the fees, but in the fact that there are various classes of creditors who desire to control the estate.

There may be a receiver in the case; and the law provides that the receiver's fees must not exceed those allowed to the trustee. In addition to that, the referee is paid 1 per cent on whatever dividends are paid, and twenty-five cents for each claim filed; and there is a filing fee of $30, $15 of which goes to the referee in bankruptcy, $10 to the clerk, and $5 to the trustee. There is, in addition, an attorney's fee allowed to the petitioning creditors, to the receiver, to the trustee, and to the bankrupt. These fees, however, are so small that the ordinary bankruptcy estate is not attractive to the attorney.

Advantages of Voluntary Assignment

It is true, as explained in a previous discussion, that the expense attendant upon a voluntary assignment for the benefit of creditors is less than the expense of a bankruptcy proceeding. There are many reasons for this. It is not that the fees are less, but the creditors under a voluntary assignment may do many things that cannot be done under bankruptcy. For instance, they may take their own time about winding up the estate; they may conduct the business as they see fit; they may wait and dispose of the goods in a favorable market.

Another reason is that bankrupt sales are notoriously sales at a discount, and therefore it may be expected that assets that are sold in bankruptcy will produce less than those sold under an assignment. As a matter of fact, a man who makes an assignment for the benefit of credi-

tors will usually omit his family claims and will try to do what he can to save himself from the stain of bankruptcy; whereas, if he goes into bankruptcy, every claim that exists against him is inevitably filed in the bankruptcy court.

But there are some cases where the credit man should insist on bankruptcy. If the man is dishonest, the creditors should not give him a release under an assignment for the benefit of creditors. It is wrong to the honest man to give a dishonest man a receipt in full, and allow him to go and benefit by his dishonesty. It is right under such circumstances that he should be put into the bankruptcy courts; and, moreover, the bankruptcy courts are frequently the only place where you can prove his dishonesty.

Examinations in Bankruptcy

The bankruptcy court is perhaps the only court in which it is permitted to examine a wife against her husband, or a husband against his wife. In state courts you cannot summon a wife to testify against her husband, or a husband to testify against his wife, any more than you can subpœna an attorney at law to testify against his own client as to communications between them. But it is not so in bankruptcy.

Also in bankruptcy any man may be called before the court to testify in relation to the affairs of the bankrupt, and particularly in relation to his property, and hearsay evidence is admissible. This gives an excellent opportunity for "fishing excursions." If a man on the street has said that he heard that Tom Jones said that John Brown had smuggled away some goods, you can call Jones and ask him if he said that, and if he says, "Yes," you ask him, "Who told you?" "Well, it was Smith." Then you may call the other fellow and bring them all in, and

after a while you run the rumor to cover, and discover either that it is a mere rumor or that it amounts to something, in which latter case you have some clue that may lead to the discovery of the hidden goods.

Grasping Creditors

There are other reasons why bankruptcy is sometimes necessary. Perhaps an honest man cannot otherwise obtain the release to which he is entitled. I have known many cases where the creditors as a whole did not wish to throw the debtor into bankruptcy, but some one creditor believed that, by refusing to agree to an amicable adjustment, he would force the other creditors to pay him one hundred cents on the dollar, to get him out of the way. He figures that his claim is small, while the aggregate of the other creditors' claims is large; and to put the debtor into bankruptcy would mean a loss to them of more than his whole claim; and so he will not come into the settlement. We meet with such people every day. Of course, if such men find out that you will not be coerced into paying them out, they will not cause much trouble. But sometimes the creditors, in their eagerness to save from bankruptcy some man who does not deserve that punishment, or to save themselves the serious loss which a failure entails, mistakenly pay such a claim just to get it settled, and the successful bluffer tells another, "I held them up; they paid me in full," and the result is that a regular crop of those fellows comes along.

Composition

Now, bankruptcy will compel each person to take what is offered. You know we have such a thing as composition in bankruptcy. A man who goes into bankruptcy does not necessarily have all his property sold out. He

may go into bankruptcy and propose an honest composition, and, if the majority in number and amount of creditors petition the court to allow it, the court will decree that he is entitled to it. Whatever the settlement may be, the balance of the creditors are bound by it; and so the honest man gets his due.

Adjustment Bureaus

The credit man has found that the bankruptcy statute is almost a necessity to him. He must either have bankruptcy or an association where voluntary assignments can be taken care of. In Los Angeles and on the Pacific Coast generally, the boards of trade are very well organized, and most insolvent debtors make assignments for the benefit of creditors through adjustment bureaus; but in the Eastern states these boards of trade did not formerly exist. The National Association of Credit Men is organizing adjustment bureaus in all our great cities, but in the East it is uphill work and the adjustment bureaus are not as strong there as they are here. In some of the large Eastern cities nearly every one who fails finally gets into the bankruptcy courts.

Electing the Trustee

The most important thing about a bankruptcy estate is to see that the proper trustee is elected. I remember the case of a Chicago man who was denouncing the bankruptcy statute, and when we asked him why, told us about a claim of his for $2,000 against a man in Sioux City, which he had placed in the hands of lawyers there. He could not get any satisfaction out of his lawyers, and finally went himself from Chicago, and when he reached Sioux City found that the lawyers who represented him also represented about $20,000 of claims belonging to

the bankrupt's mother, father, sisters, and brothers. His own claim, added to these, had helped to elect the trustee, who was a brother of one of the attorneys.

The Chicago man investigated the whole matter personally and came to the conclusion that all those family claims should have been thrown out. Because this was not done he was denouncing the whole bankruptcy law, but the trouble was with the trustee. Now, if the creditors, or the credit men, would see to it that their claims were properly voted in bankruptcy for a proper trustee, the bankruptcy statute would not, I think, be in such disfavor.

The Referee

Perhaps it may be well to explain the difference between the referee and the trustee. The referee in bankruptcy is practically the court. The bankruptcy statute used two phrases—"the judge," and "the court." The word "judge" is used a few times in the statute, but generally the word "court" is used. Now, as a practical proposition, the court is the referee. The judge is the United States district judge, who, in bankruptcy proceedings in this district, does nothing except adjudicate and refer the matter to a referee and act as an Appellate Court. The judge, immediately upon the adjudication, refers it by order of reference to a "Referee," who then becomes the court, and all proceedings in the bankruptcy case take place before the referee, acting as a judge.

The Trustee Represents the Creditors

The trustee is the party elected by the creditors themselves to take charge of the property of the bankrupt, and the court has nothing to do with this election. That is why credit men are responsible for maladministration in bankruptcy matters where it does occur.

The referee calls a meeting after a bankruptcy adjudication, and sends notice to every creditor that at a certain time and place there will be elected a trustee. The creditors come together accordingly, and nominate Mr. Jones or Mr. Smith for trustee. The court has nothing to do with it except to approve their choice. The trustee qualifies by filing a bond, and he becomes thereby invested with the title to all property of the bankrupt throughout the United States of America.

Responsibility of the Creditor

Credit men often simply file their claims in the bankruptcy courts, and then forget all about them until they receive a check for a dividend; and when it is a small dividend, they denounce the bankruptcy law. They ought to realize that they must give some of their time to the administration of the statute. Formerly they gave a great deal of time to the collection of their bad accounts; for it was a case of first come, first served. The man who levied the first attachment on a debtor's business was paid in full, and the man who came along last got nothing. In those days the credit man led a strenuous life. Nowadays he gives more time to the granting of credit and less to the collection of debts, because he knows that in case of bankruptcy he will get his share of what there is. But he must realize that there is a certain personal responsibility resting on him for the proper administration of the bankruptcy law.

Preferences

Everything in the administration of the estate depends upon the trustee. He has every right and every obligation that the bankrupt has; and he also has rights that the bankrupt has not. For instance, a voluntary pay-

ment by a bankrupt to a favored creditor may be perfectly good as between the bankrupt and that creditor; but, under certain circumstances, it is absolutely unfair to the other creditors, and the trustee has to consider not only the rights of the bankrupt, but the rights of creditors, and must recover any unlawful preferential payments.

To recover unlawful preferences it is necessary to throw the debtor into bankruptcy. The ratable distribution of the assets among the creditors is, in fact, one of the prime objects of the law. Now, you cannot recover every preference that has been given, but only payments that have been made within four months of the bankruptcy, and then only under certain conditions. The person receiving the payment must have had reasonable cause to believe that the debtor was insolvent at the time he made the payment. That is not hard to prove, because a person cannot shut his eyes when he receives a payment and simply say, "I won't investigate, for I don't want to know anything about the man's condition." Nearly all credit men get caught at one time or another in that way. They think, "Well, if I don't make any investigation of this thing, they cannot say I had any reasonable cause to believe the man was insolvent."

It has been said that it would constitute reasonable ground for belief that a usually well dressed fellow were insolvent if he were met in shabby attire. If after this you should receive a payment from him, it might be held an unlawful preference on the ground that you had reasonable cause to believe the man was insolvent. In other words, it is your duty, when anything occurs to cause you to take notice, to investigate and find the complete facts.

I recall the case of a wholesale merchant to whom another wholesale merchant was in debt. One day he went down to the debtor's place and found no one there but

the clerk. The store contained some potatoes, a pair of scales, the ordinary office furniture, and so on. The creditor asked the clerk where the proprietor was, and the answer came, "He's been gone about three days, and I'm wondering where I'm going to get my pay for my work here." "Well, when do you expect him back?" "I don't know." "Are you selling as usual?" "Yes." "How much will you take for that scale?" "I think it's worth $10." "All right." The creditor bought nearly everything in the store and moved it across the street to his own store.

When the other creditors came to investigate they found an empty store and they threw the debtor into bankruptcy. The trustee then demanded the return of the hundred and fifty dollars' worth of stuff that the wholesale merchant had taken out, and the creditor who had bought the stuff came up to court and said, "Mr. So-and-so might have been a millionaire, for all I knew. I hadn't any knowledge or notice that he was insolvent. I simply went down and bought that stuff and credited it on my bill." "But," the court said, "you're a produce man; you are not selling scales, counters, and desks, are you?" "No." "Then what did you buy those things for? You bought them because you wanted your bill paid?" "Yes." "Why did you want the bill paid so badly as that?" "Well, I didn't know when that fellow was coming back." "Exactly. Well, he didn't come back," said the Court. "And so you will have to give the goods back."

The worst part of it was, that in the meantime the creditor had sold the stuff to a second-hand man for about $40; and when he offered the trustee the $40, the trustee said, "No, I want the value that you took it at; the amount you paid for it." "Well, it wasn't worth that." "Then

why were you buying it?" He answered, "I won't pay the valuation." But the trustee sued him and he had to pay it.

Now, that is an illustration of the fact that anything unfavorable you may hear about a man's financial condition puts you upon notice that that man may be insolvent. If, in your credit business, you find that a man has bill collectors after him; if you go into his store and see three or four other merchants around there after money; then you have reasonable cause to believe that man is insolvent, and, if you take money from him to the prejudice of his other customers and he is insolvent, you will have to account for it, because, if investigation would have shown insolvency, you are supposed to have made the investigation.

Preferred Claims

Of course, there are certain debts that are properly preferred. Not every payment constitutes a preference for which you can throw a debtor into bankruptcy. All labor is given priority to the extent of $300 if earned within three months before the filing of the petition, and there are other things entitled to priority, such as taxes, costs of preserving the estate, costs of administration, filing fees, and claims for debts—all of which are given priority under the laws of the state. Liens made more than four months prior to the filing of the petition, liens given for a present valuable consideration, and payments made without the parties having any reasonable cause to believe that the second party was insolvent at the time, are also entitled to preference. In other words, not every payment made within four months is void. For instance, where there is a present consideration, as when a man delivers goods and receives his payment for them, such

payment does not constitute a preference. Or, if a creditor has a claim against a bankrupt, and receives a payment, and after receiving that payment, although he may know that the man is insolvent, gives him further credit to the extent of the payment received, the courts will allow that payment to stand. Such a transaction, if in good faith, does not injure the other creditors.

Discharge in Bankruptcy

I come finally to the question of discharge in bankruptcy. Courts favor discharges in bankruptcy for the same reason that they favor a ratable distribution of assets. If you are in court seeking to set aside a preference, seeking to recover something that a creditor has obtained within four months, or seeking to throw a man into bankruptcy, and the court sees that what you are seeking is equitable and that, if it is denied, some one is going to be injured, you are two-thirds through with your case. My own personal experience has been of this nature, and when I go into court I know that I have the advantage of the man opposed to me, because I represent creditors entitled to redress, and the law favors the ratable distribution of assets.

On the other hand, the law also favors the discharge of a bankrupt, and it is almost impossible in this jurisdiction to have this discharge denied. It must be an absolutely sure case. There must almost be proof sufficient to convict in a criminal action in order to justify the court in denying a discharge in bankruptcy. I have had some of these cases but not many. Knowing the reluctance of the court to deny such discharges, I have been compelled in a great number of cases to advise creditors not to oppose the discharge, because it would be decided against them.

Grounds for Denying Discharge

The statute, however, provides many grounds for denying the discharge. For instance, it may be denied if the bankrupt has committed an offense punishable by imprisonment as provided by the Act; that is, if he has, before or after his discharge, knowingly and fraudulently concealed from the trustee any property belonging to the estate in bankruptcy, or has made false oath or account in relation to any proceeding in bankruptcy.

You see this is very restricted. Either the bankrupt must have concealed his property, or some of it, or he must have lied somewhere along in the bankruptcy proceeding; otherwise you cannot prove that he has committed an act punishable by imprisonment. Now, this does not mean that a prosecution must follow, or that the evidence must be sufficient to bring about his conviction by a jury; but you must prove with reasonable certainty that he has committed perjury or concealed his property.

Destroying Records

But there are other reasons for denying a man a discharge in bankruptcy that credit men should, perhaps, pay more attention to. A discharge may be denied when the bankrupt, with intent to conceal his financial condition, has destroyed, concealed, or failed to keep, books of account or records from which such condition might be ascertained. This is not so unusual as might be supposed. In one case, the day before he went into bankruptcy, an insolvent debtor destroyed all the books and papers from which his financial condition might be ascertained, except his ledger. That was a very unfortunate thing for him to do. He claimed that he did it honestly; that he did not know it was forbidden by the statute; that he did not think those records were of any importance because they were

only his sales slips, check books, and old checks, which were ancient history; and that the ledger showed his true financial condition. But, unfortunately for him, his creditors considered those records very necessary to show what had become of a great many thousands of dollars of his assets.

False Statements

A discharge may also be denied when it can be shown that the bankrupt has obtained money or property on credit from any person upon a materially false statement in writing made to such person or his representative for the purpose of obtaining such credit. This is the "false statement in writing" provision; and the time will come when no credit man will give credit without a statement in writing, any more than a bank would give you a loan today without such a statement. When that time comes, there will be fewer discharges in bankruptcy. The state of California has just passed the "False Statement in Writing Bill" for which the Credit Men's Association has so long been fighting. This provides that any false statement in writing hereafter made by any person in California for the purpose of obtaining credit, given either to the commercial agencies or to the credit man, makes the person guilty of misdemeanor. This is of great advantage to the credit man, for the man who makes a false statement hereafter will not only be subject to punishment under the state law, but will be unable to obtain his discharge in bankruptcy. Any false statement in writing made to any creditor may be taken advantage of by any other creditor in objecting to the discharge.

Concealment of Property

Discharge may also be denied if, at any time subsequent to the first day of the four months immediately pre-

ceding the filing of the petition, the bankrupt has transferred, removed, destroyed, or concealed, or permitted to be removed, destroyed, or concealed, any of his property, with intent to hinder, delay or defraud his creditors.

Discharge Within Six Years

Discharge may be denied if the debtor has been granted a discharge in bankruptcy in voluntary proceedings within six years. In other words, a man may not obtain two discharges within six years, provided the first bankruptcy was voluntary. It is therefore important for the creditors always to have a man file a voluntary petition when they can get him to do so, because it will check future activities.

Contempt of Court

The final ground for denying a discharge is the refusal of the bankrupt in the course of the proceedings in bankruptcy to obey any lawful order of, or to answer any material questions approved by, the court. In California that does not mean as much as it does in the East. It is a very frequent order of Eastern courts that a bankrupt shall produce property that he has not accounted for.

Liability of Stockholders

There is one thing that credit men should remember: The discharge of a corporation does not discharge the stockholders from any liability imposed upon them by the statutes. Every credit man in California, when he gives credit to a corporation, not only considers the financial responsibility of the corporation, but he also considers the financial responsibility of the stockholders of that corporation, because, in this state, every stockholder of a corporation is liable for that proportion of its debts

which his stock bears to the whole amount of the subscribed capital stock of the corporation. If, therefore, the corporation is of insufficient financial responsibility, and the stockholders are well known to be perfectly responsible financially, the credit man will immediately grant a credit based on the responsibility of the stockholders, and, as I said a moment ago, the discharge of the corporation has no effect whatever upon that liability of the stockholders of the corporation.

Fraudulent Debts Not Discharged

Certain debts are not discharged at all in bankruptcy; and that is where financial statements become of so much value. A credit or property obtained by false representations or under false pretenses, creates a debt that cannot be discharged in bankruptcy. Sometimes I have wondered that the credit men do not get together on this written statement proposition and absolutely demand it. It is impossible for one individual wholesale house to demand a statement in writing before giving credit to its customers, for such a house would not have any business. If only one bank in Los Angeles demanded a written statement, and all the others gave credit without it, the bank demanding the statement would certainly lose some customers, and a wholesale house following a similar course would lose still more. It must be a general agreement and arrangement among all of the houses to require written statements. Now, if a false written statement is given to a house and credit is granted upon that statement, the debt remains forever. A man cannot be discharged from that obligation. Although his general discharge may be granted, yet that particular debt remains a debt, and, if at any time in the future the discharged bankrupt acquires property, the debt may be collected.

Reclamation Proceedings

Another proceeding that is not used as much as it should be in California, although it is used frequently in the East, is what is known as a reclamation proceeding. If a man makes a false written statement to you, or even an oral statement that is false in any respect, and thereby obtains from you goods, those goods may be reclaimed if they can be found in his possession at the time of his failure.

Not long ago a wholesale house in Los Angeles sent its salesman to Salt Lake City, and the salesman went into an establishment there supposedly worth from $75,000 to $100,000, and, after obtaining an order for two carloads of goods worth about $3,500, said to the customer, "Before shipping this, I would like to have a financial statement." The customer replied: "I have just given a financial statement to Dun and Bradstreet, and if you will examine that statement I think it will be sufficient." The Los Angeles house accordingly got a statement from either Bradstreet or Dun before shipping the goods, and that statement showed that the Salt Lake house had a net worth of about $75,000. The goods were therefore shipped; but within a week after their arrival in Salt Lake City the purchasing concern had gone bankrupt.

The Los Angeles house immediately wired a firm of attorneys in Salt Lake City, asking whether the goods were still in the possession of the bankrupt. The lawyers reported that the goods were still in the house, and immediately reclamation proceedings were commenced in Salt Lake City on the ground that the goods had been obtained under false representations as to the financial worth of the concern, and the Los Angeles concern got them back.

Future of the Bankruptcy Law

I have tried somewhat briefly to give you a general idea of bankruptcy proceedings. I know that the bankruptcy statute is one that will remain on the books, one that credit men will have to consider more and more in the granting of credit in the future, and one that will be necessary for them to study and to understand thoroughly, because no man should grant a credit without reference to that statute.

CHAPTER XIII

INSURANCE IN COMMERCIAL AFFAIRS

By Warren C. Kennedy

Insurance in its different forms is steadily becoming a greater factor in the business world, as is evidenced by its enormous growth in volume and the widening field for its varied activities. It is therefore one of the important collateral duties of the credit man to obtain a proper understanding of the principles of commercial insurance.

Kinds of Insurance

The three great divisions of insurance are life, fire, and marine; but besides these there are scores of other forms of greater or less importance, including personal accident; health; employer's liability; public liability; steam boiler explosion, fly wheel, elevator; team liability; damage to crops by hail or fire; plate glass breakage, sprinkler leakage; defective titles; earthquake; cyclone; riot and strike damage by violence; burglary; securities in transit; luggage in transit; live stock; automobile loss from fire, theft, or in transportation; owner's liability for injury caused to person or property; loss of rent by fire or defaulting tenents; loss of leases by fire; loss of profits by fire; physicians' liability; credit indemnity.

Closely related to the miscellaneous insurance lines are the departments of insurance companies dealing with bonds—fidelity, contractors, bail, in legal proceedings, etc.

Injudicious Insurance

As with other things necessary and useful to mankind, insurance is often misunderstood, overdone, or insufficiently done. Sometimes it is placed with an irresponsible company or where a risk does not exist, and sometimes a real hazard is left unprotected. Some of us insure too much and injudiciously, others not enough to protect their business from failure or their widows and orphans from poverty.

Importance of Preventive Measures

Insurance does not create or save wealth, it merely distributes the losses of the few upon the many. In other words, all insurance losses are in the end borne by the public. The guiding principle which should always be in evidence with any hazard, whether insurable or not insurable, is prevention, intelligently administered: fire prevention, accident prevention, prevention of many perils of the sea, of accidents to employees, of casualties, of credit losses, boiler explosions, loss of land from defective titles, losses from dishonest employees. Secure competent officers for your ships, careful foremen for your laborers, safe machinery for your workmen, intelligent credit men for your business, competent engineers for your boilers, reliable experts for your land titles, and men of good character for positions of trust.

Life Insurance for Firms

Life insurance in commercial affairs is life underwriting that a man purchases to protect his business in the event of his death. This is sometimes called partnership or corporation insurance, and in an increasing number of concerns one or more partners or corporation officials are insured for the protection of the establishment. The

death of an important member of a business house is often a great loss, and sometimes a calamity, and this risk should receive the same consideration that any other business misfortune is entitled to, in its relative degree.

If the important member of a firm is in bad health, no insurance can be had. If in good health and under sixty years of age, life insurance will often protect a valuable business, and, in turn and proportionally, the interest of the deceased partner's family therein. Business insurance will enable a surviving partner to pay cash to the deceased partner's family for its interest in the business, and this arrangement is sometimes contracted for in articles of partnership. The advantage here in many cases is mutual, the surviving partner being able to purchase the deceased partner's interest instead of having the latter's family dependent on dividends from the business without ability to assist in its responsibilities; while the family receives under this arrangement the equivalent in cash of its interest in the business, and is therefore free from dictation from the surviving partner with whom it may not be in sympathy.

Business insurance policies sometimes run to very large amounts. Some individuals are now carrying from $1,000,000 to $4,000,000 of life insurance to protect their large interests.

History of Life Insurance

Life insurance is an outgrowth of the friendly societies of three centuries ago, and these societies in turn followed certain trade and religious guilds which have had existence in European and Asiatic civilization for thousands of years.

The frequent need of assistance to bury the dead probably gave origin to a system of organized aid in families or localities; and this has developed into a large plan for

mutual contributions from the many, and thereby built up the enormous trust funds now held by life insurance companies with policies aggregating in the United States over twenty-six billion dollars.

In 1698 the Mercers Company in London undertook to furnish annuities for the widows of clergymen; but the Amicable Society of London, founded in 1706, was the first general life assurance institution ever established. However, little was accomplished before the organization of the Equitable Life Assurance Society in 1762. This old company is still operating in London; has assets of $25,000,000, and transacts its business without payment of commission to agents. This practice permits of a small percentage of expense, but limits the usefulness of the institution to a comparatively small field as compared with the commission paying companies, for, as we all know, it is human nature for the majority of men not to insure unless actively solicited to do so.

In the United States the first Freemason's Lodge was established in Boston in 1733; and later organized benevolence led to a clergymen's insurance society in 1759. Numerous other enterprises of a similar nature were started before a successful and permanent life underwriting company was launched. The great Mutual Life Insurance Company was established in 1842, and its success led to the formation of several important competing companies. Massachusetts established the first insurance department in 1855, and in Elizur Wright, insurance commissioner, found a master mind whose ability and writings wrought sound principles and a scientific system out of the loose practices which had been prevalent. The laws regarding life insurance have been repeatedly revised in the interests of the policy holders so that these now have, under all circumstances, an equity in premiums paid.

Assessment Societies

An important feature in American life insurance has been the great growth of assessment societies. Their success has been mostly with men ignorant of insurance, and attracted solely by the low cost. Unfortunately, many of these societies have been in unskilled or unscrupulous hands, resulting in a large percentage of failures, with many families left unprotected when most in need. Probably the most successful association of this character was that which recently discontinued the taking of more risks on an assessment basis, and adopted the methods of the "old line" companies for all its new business because of the uncertainties of the assessment plan.

For business or corporation insurance, assessment societies do not appear to be available.

Amount of Life Insurance in the United States

In 1909, life policies and certificates in the United States numbered 36,500,000, amounting to $25,175,797,538, while in all the rest of the world life policies in force amounted to only $8,742,509,421, showing that the United States has in force three-quarters of the life insurance of the world.

History of Marine Insurance

This is the oldest and most complex form of insurance, and is doubtless the least understood by the ordinary purchaser. A kind of indemnity for marine losses in the form of loans was practiced by the ancient Greeks and was fully described by Demosthenes about 350 B. C. Money was advanced on a ship or cargo to be repaid with large interest if the voyage prospered, but not to be repaid at all if the ship were lost. Eight centuries later, A. D. 533, the Roman Emperor, Justinian, enacted laws regulating the rate of interest to be paid on such loans.

Marine insurance was probably practiced in France in 1182, having evidently been adopted from a practice established in Italy. In England it was in active use in 1555, over a century before fire insurance was established; and in Queen Elizabeth's time the British Parliament declared it to have existed from time immemorial.

Modern English and American marine insurance law is largely based on the rules and principles laid down by William Murray (Lord Mansfield), presiding justice in the Court of Kings Bench from 1756 to 1788. The consummate ability of this masterly jurist has caused him to be regarded as the founder of modern commercial law, of which insurance law is only an important part.

Nature of Marine Insurance

Marine insurance is a contract by which the underwriter agrees for a premium to protect the assured against loss arising from certain perils or sea risks to which a ship or merchandise may be exposed during a specific voyage or period of time. Losses are divided into three general classes:

(1) Claims for total losses.
(2) Claims for general average.
(3) Claims for particular average.

General Average

The terms general and particular average are obscure and confusing to the layman; and, on account of the endless variety of sacrifices and accidents which occur to vessels of the merchant marine and their cargoes, even admiralty lawyers, judges, and juries find difficulty at times in determining the correct classification of losses subject to litigation.

Defined briefly, general average is a loss by sacrifice.

Particular average is a loss by accident. Common forms of general average sacrifices, which must be voluntary, are as follows: throwing cargo overboard to save the ship; damage to the unburned cargo by water poured over it to extinguish a fire; loss or damage to ship or cargo by the voluntary stranding of the vessel for the common safety.

The theory of a general average loss or sacrifice is simple enough. For instance, we will assume that you are the owner of 100 barrels of cement on a vessel in distress at sea. For the safety of the vessel and balance of cargo, all your cement is thrown overboard, and the ship and other cargo thereby saved. It is only common justice that you should be reimbursed for your loss by a pro rata contribution from the ship and cargo saved by the sacrifice of your cement.

When a shipper holds the proper form of policy, the marine insurance company takes care of his interest by paying the contributions levied upon him for general average.

Particular Average

While general average represents a voluntary loss by sacrifice, particular average signifies the damage to, or partial loss of, ship or cargo by some fortuitous or unavoidable accident, and includes every form of loss that is not a total loss or a general average sacrifice.

If a ship takes fire, and water is poured into the hold to extinguish the fire, the cargo damaged by the water would be a general average loss, this being a sacrifice; but the cargo damaged by fire only would be a particular average loss, because the damage from that cause was accidental.

The usual marine policy covers total and general

average losses, and is known as the "Free of Particular Average" policy, meaning that the underwriter is not responsible for particular average losses. Another policy with a necessarily higher premium rate is known as the "Particular Average" policy, and covers total, general, and particular average losses.

Lloyds

Closely associated with the development of the British merchant marine, and with marine insurance the world over, is Lloyds—a corporation having as its particular objects, first, the writing of marine insurance; second, the protection of the interests of the members of the association; and third, the collection, publication, and diffusion of intelligence and information with respect to shipping.

This association of merchants, ship owners, underwriters, and brokers had its origin in a seaman's coffee house established by an enterprising man named Edward Lloyd, first heard of in the year 1688. It was his systematic gathering of maritime information which made his coffee house the principal meeting place for those interested in merchant marine affairs, and from this beginning has grown one of the greatest organizations of the commercial world.

Fire Insurance

Fire insurance is the most familiar branch of underwriting to the merchant, manufacturer, and banker, many of whom have no dealings in marine insurance, and but little acquaintance with the life policy. While history shows that for 2,500 years efforts have been made to relieve sufferers from fire by some form of public contribution, fire insurance in the sense known to us, was begun in London in the year following the great fire of 1666. In

this conflagration, 85 per cent of the buildings of the city were destroyed, with a loss of about ten million pounds, equal, it has been estimated, to three hundred million dollars in our day. There was no insurance, and the great metropolis did not recover from the effect for a number of years.

It might be well here to compare this with the San Francisco fire of 1906. The Chamber of Commerce report states that about 3,000 acres were burned over, containing 520 blocks of about 25,000 buildings, with a loss of nearly $350,000,000 and insurance approximately $235,000,000. The benefits of insurance are here clearly shown. The general ratio of insurance to the value of property destroyed was thus about 70 per cent.

In 1910 there were in the United States fire insurance companies of all kinds, to the number of.....624
With total assets of..... $580,600,192
Annual income..... 295,644,715
Annual expenditures..... 256,681,453
Risks written.....36,357,713,046

Average rate.....$1.0822

Insurance Rates

Insurance rates are necessarily based on the character of the risk. A dry cleaning establishment using benzine and gasoline constantly, located in a frame building and exposed to hazard of fire from adjoining buildings, may have a rate of six to ten per cent, and even then some companies will not take the risk. Non-inflammable materials, however, kept in sprinklered, fireproof buildings, not exposed to fire from neighboring buildings, have been insured at a cost of about one-tenth of one per cent. Between these two extremes the rates vary directly with the conditions.

The California Form of Policy

In California since the San Francisco conflagration of 1906, the law requires that only the California form of policy be used. This is a modification of the standard form of policy of the State of New York, which became mandatory for use in that state in 1887. It was carefully prepared, and, while not a perfect instrument, it is acknowledged to be the best form ever generally used. Billions of dollars of contracts have been written on it, and many legal decisions have established its meaning and its substantial fairness to all concerned. It is an instrument of 2,536 words, and is written in plain, non-technical language.

It should not be necessary to caution business men to see that their property is properly described in the policy, yet many are lax in this respect, and local agents are frequently more anxious to sell a policy than to describe properly that which the insurance is intended to cover.

Co-insurance

A co-insurance clause is a part of all policies issued in France, Germany, and some other European countries, but is not yet general in Great Britain and the United States. Ten of our states prohibit a co-insurance clause, and many objections have been made to this form of policy, but insurance experts generally are in favor of it as being a step toward a more correct scientific rating.

An able writer speaks of co-insurance as follows:

"The direction in which fire insurance calls most pressingly for improvement is the extension of the principle of co-insurance. The importance of this can be understood only by remembering that the aggregate losses of the community by fire are chiefly made up of innumerable small fires and not of sweeping conflagrations. The ex-

perience of every company confirms the general truth, that the number of fires in which a building is totally destroyed, or in which the loss amounts to the greater part of the property exposed under the same risk, is comparatively very small. It may be asserted with confidence that in the grand aggregate of the business, much more than three-fourths of the loss occurs in fires in which less than one-tenth of the insurable value at risk is destroyed.

"In an equitable adjustment of rates, the amount insured, as compared with the value exposed, is a prime element; and premiums might justly form a scale highest on the smallest fractions of value and diminishing rapidly as the percentage of insurance increases.

"The correct principle is, that when a proper rate for a class of risks is found, the insured may protect at this rate any percentage of such risk, and in case of fire shall be indemnified for the same percentage of his loss.

"The American clause provides: 'If at the time of fire the whole amount of insurance on the property covered by this policy shall be less than 80 per cent of the actual cash value thereof, this company shall be liable only for such portion of such loss or damage as the amount insured by this policy shall bear to the said 80 per cent of the actual cash value of such property.'

"The most serious objection to this system is the fact that a fire may promise profit to the insured. The cordial support of the mercantile community in the great cities and of the most intelligent state officers has been given to it."

Conflagration Loss

The great problem of the fire companies is the conflagration loss. This factor must receive attention from the insurer as well. To secure proper protection he

should select companies who from their history have established a satisfactory record for care in assuming conflagration risks, and a good reputation for settling losses.

Probably the best guide we have in that respect in fire insurance is the report of the special committee of the Chamber of Commerce of San Francisco on settlements incidental to the San Francisco fire. The National Association of Credit Men also published a somewhat similar report, and from these we learn which companies met their losses honorably, and which took advantage of the insurer by unfair settlements.

As long as the Roll of Honor Companies are available to you they should receive your business. The sacrifices these companies made in the dark days of 1906 in San Francisco should bear fruit in our support for many years to come.

Employers' Liability Insurance

Employers' liability and workmen's compensation insurance is an important development of the present generation, and is largely the outgrowth of the English Employers' Liability Act of 1880. This was followed by a similar act passed by the Massachusetts legislature in 1887, and other states have been continually passing and amending the liability statutes ever since.

The nations of Europe have gradually abandoned the principle of law that required the employee to prove negligence in order to secure damages. This old rule has for generations worked the greatest hardship to those least able to bear it. The average laboring man when seriously injured is in no position to conduct a successful suit for damages against an employer of means, of greater experience, and who probably has more able legal advisers. In the event of the death of the employee, his

widow and children are even more helpless. In either case the victim's needs and expenses are multiplied by hospital and surgeons' bills, and his income is ordinarily absolutely cut off. The tendency of the times is clearly to place the burden of expense for accidents upon the industry itself, first by employers' liability laws and now by workmen's compensation laws or compulsory insurance.

California's first step in this direction was the adoption of the Roseberry liability and compensation law, which became effective on September 1st, 1911, and was in force until the close of 1913. This law was optional in allowing the employer to take his choice of electing to conform to its provisions and limiting his liability according to its schedule, or assuming the liability of the old common law which has no limitation. Only a small proportion of the employers of the state have elected to come within the provisions of the Roseberry law, so that less than ten per cent of the working population today come under the compensation features of the act.

On January 1st, 1914, the Roseberry law was succeeded by the Boynton Workmen's Compensation Insurance and Safety Act, which for the first time in California introduces compulsory compensation—excepting in agricultural pursuits and to domestic servants—for all accidents to employees resulting in more than two weeks' disability, and this compensation must be paid by the employer regardless of who is at fault.

Such advanced legislation with its new and serious problems will probably result in a greater necessity than ever for insurance to cover the increased obligations of employers, making a knowledge of the accompanying insurance problems especially important.

The Boynton Act was really the work of the California Industrial Accident Board, which body advised the

state legislature that the rates of the employers' liability insurance companies for workmen's compensation under the Roseberry law were excessive, and the board asked the legislature to establish a state insurance fund, beginning with the operation of the new law, to afford employers' insurance at reasonable rates. The legislators accepted the recommendation of the board, and, notwithstanding the most bitter opposition of employers' liability insurance companies, the bill was passed, including a provision for a competitive state insurance fund and a state rate-making bureau with power to name liability insurance rates, just as the railroad commission can dictate freight rates.

The purpose of the legislature in passing this statute was to reach a great social and economic problem—the third greatest cause of poverty.

The four great causes of poverty are:

(1) Sickness.
(2) Lack of employment.
(3) Industrial accidents.
(4) Death of the father before his children have become self-supporting.

In the important work of relieving the distress of this third cause, it is the aim of the proponents of the Industrial Accident Law to place upon the consumer the cost of providing a moderate compensation to injured employees and their dependents; and it is claimed that California has the best compensation, insurance, and safety act in the world. Even though every employer should expect to add the insurance cost to the selling price of his wares, as he would in the event of an increase of freight rates, the situation which many of them confront with the new year offers an interesting problem to the student of insurance.

Public Liability Insurance

Public liability insurance is a direct outgrowth of employers' liability insurance and is written to protect the employer in case of accident to third parties caused by his employees. In some industries this is a considerable risk, as, for instance, with building contractors. It is not unusual to read of serious accidents to employees of one contractor caused by the employees of another, especially in the case of persons who are working several stories below others.

The same principle covers vehicle and team insurance, giving protection in the event of damage caused to third parties by runaway or collision.

Steam Boiler Insurance

Steam boiler insurance as conducted in this country since 1866, carries with it the very useful periodical inspection of the boiler, on which the owner generally relies to keep him informed as to its safety; and it is a fact that manufacturers of boilers are glad to carry this insurance on boilers in their own service so that expert inspectors can be relied on to make a regular examination and report. In spite of this care, however, there have been reported in the last forty-one years 10,501 boiler explosions in the United States, Canada, and Mexico, causing 10,884 deaths and injury to 15,634 other persons.

The usual policy for a single boiler is for a maximum liability of $5,000 written for three years at one per cent, or $50, for the term. While fire insurance will carry a higher rate for a hazardous risk in practice, no insurance can be had for any sum on a boiler regarded as unsafe, and an owner would surely be liable for damages on the ground of negligence for any accident following the using of a boiler condemned as unsafe by a qualified inspector.

Personal Accident Insurance

Personal accident is an important division of casualty insurance, but does not often enter into commercial affairs. I see no reason why it should not be considered a valuable form of business insurance in the same way as is life insurance, though necessarily to a more limited extent. As business insurance, the weekly indemnities should be dropped, and the policy carried, perhaps, on the life risk only. The premium for this is only $2.50 per thousand per annum, so that a $20,000 policy would cost only $50 a year.

Accident insurance was begun in England in 1849 for insuring against the consequences of railway accidents. In 1856 all kinds of accidents were included in one policy, and premiums were based on the hazard estimated to follow one's occupation.

Credit Insurance

Credit insurance has never become an important general factor in business. I know of but two companies—one American and one English—operating in the United States, and only one of these is represented on the Pacific Coast. In the operations of these companies during about 17 years to 1911, they received:

In premiums.....$36,590,727.02
And paid for losses.....$16,815,780.63

This is a loss ratio of 46 per cent, which is fair to insurers if the business is properly conducted. The premiums of the two companies for 1910 amounted to $1,434,987.43; and losses paid during the year were $784,618.63, or nearly 55 per cent.

Credit insurance does not insure a man for his total loss, as the contracts are written to insure against ab-

normal losses only. This is arranged by providing in the contract that a usual loss—of, say ½ of 1 per cent of annual sales—should be borne by the insurer. This is called the "own" loss. If the loss for the following year is 1 per cent, the insuring company would pay the difference only between the "own" loss of ½ of 1 per cent and the actual loss of 1 per cent.

On sales for the year of.....	$1,000,000.00
A 1 per cent loss would figure...	10,000.00
An "Own" loss of ½ of 1 per cent would be.....	5,000.00
And the insurer would recover the balance of.....	5,000.00

Always provided that the balance did not exceed the amount of his policy.

Credit insurance has not yet established a firm hold on business, as its average losses paid of less than $1,000,000 a year would prove. The capital invested is not large, and on the Pacific Coast there appears to be no competition, doubtless owing to the difficulty of introducing the business. The credit losses reported by the mercantile agencies run over $150,000,000 a year, yet these insurance companies do not cover 1 per cent of the reported losses. There is merit in the theory; but the practice is difficult to work out.

How to Insure

The problem of concentrated and scattered risks is often confronted. Many wealthy concerns with sufficiently scattered risks carry the hazard themselves without insurance. This is thoroughly businesslike when the losses cannot be severe, and the risks are unquestionably small and scattered. Many houses insure their concen-

trated risks and assume their several scattered risks. A mill may be insured to a large amount; but its separated buildings for offices, power house, stables, garage, storehouses and shops, may properly bear no insurance if no great value is at risk in each, and they are safely protected from a general fire.

Every concern carries some risks; for no one would take policies to protect from every possible danger. The important question is as to the most businesslike method to pursue. The necessity for carrying substantial insurance on our larger risks is usually imperative, but the wealthier the concern becomes and the more distributed its hazards, the more it can afford to carry its own insurance. This applies in practically every line.

If a wealthy concern has several men who may be competent to manage it, the house may not need business life insurance. If several trained men are not available, life insurance should be considered.

The cost of employers' liability insurance to a large employer will frequently justify him in using the same amount of money to make his own settlements with his men; whereas to a small company the amount at risk might be too great.

Some of the great steamship companies are themselves carrying a large proportion of the marine risk, as their many ships are widely scattered. This was true with the owners of the Titanic. Some people thoughtlessly assume that everything should be covered by insurance, forgetting that insurance is a considerable expense, and that, if this expense can be saved, the savings will cover many of the ordinary risks of the business. The business men who do not insure their large risks from fire are, however, happily growing more rare, and partly for the reason that they cannot secure due credit consideration unless they do.

Defective Policies

There have been many cases of improperly written policies with wrong or defective descriptions, in which the insurance companies have assumed that the policies meant something else, and have paid the bill. In another instance, an acquaintance of mine conducted a business as a partnership and forgot to transfer his insurance when he incorporated. After a destructive fire, the insurance companies compromised with him for the sake of policy; but when there are large amounts involved in a conflagration, do not expect the underwriters to overlook your carelessness. It is too much to expect of human nature. The moral is to buy your insurance from insurance companies of good reputation, and to place it with agents unquestionably competent to advise you. Finally, remember that prevention saves loss.

CHAPTER XIV

CORPORATIONS

By Judge Frank G. Finlayson

When so large a proportion of the business of the country is carried on under the corporate form, it is absolutely essential that the credit man have at least a general knowledge of the organization of the corporation, its methods of acting and carrying on its business, and more particularly of the responsibilities and liabilities of the corporation itself, and of its officers, directors, and stockholders. For this reason a discussion of the more important points of corporate organization and procedure are not out of place in the present volume.

Nature of the Corporation

A corporation may be defined as an entity, created and recognized by law, and endowed with certain attributes usually inherent in an individual; as, for example, the power to conduct business, the right to commence and defend actions in law, and, most important of all, the right to maintain a continuous existence notwithstanding constant changes in its officers and membership. These, briefly, are a few of the most important characteristics of corporations.

Classes of Corporations

Corporations are either public or private. Public corporations are endowed with certain governmental powers

which they exercise in certain subdivisions or localities of the state, as cities, towns, school districts, and irrigation districts. All corporations not classed as public, are private corporations. Another way of classing corporations is to distinguish, (1) those for profit, and (2) those for some purpose other than profit.

As our purpose here is to consider only private corporations, or, in other words, business corporations organized for profit, we shall leave out of the question public corporations, and corporations not organized for profit, such as religious, eleemosynary, educational corporations, etc.

Incorporation Laws

We will take up first the methods of incorporation. The early English custom was to create each corporation by a distinct act of Parliament, or by grant of the Crown; and such act or grant constituted its charter. Today, in practically all our states corporations are organized under general laws. In other words, there is no special legislative act creating each, but a general law under which any number of corporations may be organized.

Capital Stock

Let us say a word, first, about capital stock. I wish to emphasize particularly the distinction between the capital of a corporation—capital such as any individual may own—and its capital stock. Capital, as distinguished from capital stock, or *share* capital, consists of the property owned by the corporation, without regard to whether it was contributed by the stockholders or not. The capital stock of a corporation, on the other hand, is that sum mentioned in the articles of incorporation as the sum for which the company is capitalized, and such sum may have

either a potential or an actual existence. For example, when the company is organized, and before any stock is subscribed for, the capital stock has a potential existence only; but when there are subscribers for the shares of that company, the capital stock has an actual existence, whether the money is paid in or not, for the reason that those who subscribe for the stock become indebted to the corporation to the extent of their subscriptions. For example, suppose a corporation is capitalized for $100,000, divided into one dollar shares, and that all the stock is subscribed, but none is paid. There is, in such case, $100,000 due the corporation that can be collected—$100,000 of debts—and if they are good, collectable debts, it has assets of $100,000.

Rights of Stockholders

We will consider now the relation of the stockholders to the corporation. The stockholders have no direct ownership in any of the property of the corporation. They simply own the shares; and these shares are personal property, even though the corporation may have nothing but real property. To illustrate; let us suppose that ten men own a lot in this city worth $10,000. Each of the ten men owns an equal share, the value of which is $1,000. Unless all agree to sell, the land cannot be sold; none of them can be forced to sell. Of course, each one could sell his individual interest, but the land itself could not be sold unless all agreed.

Now, let us suppose that those ten men organize a corporation, capitalized, we will say, for $10,000. They convey the land to the corporation, and issue to themselves all the stock of the corporation, each taking one-tenth, and they elect a board of directors. Those owning a majority of the stock will control a majority of the

board. They elect, say, three directors to manage the corporation, and these directors think it best to sell the land and buy other property with the proceeds. They may do so without securing the consent of each of the ten stockholders. One individual stockholder may strongly object to this sale; but he cannot help himself. The others can sell it—the corporation, rather, can sell it—because the stockholder no longer owns any interest in the land itself, but simply an interest in the corporation. The property owned by the corporation is real property; but the shares of stock are regarded as personal property.

What, then, is the interest of the shareholder in a corporation? First, the right to receive his proportion of such dividends as may be paid by the corporation; and, second, the right to receive his proportion of such assets of the corporation as may remain upon its dissolution, after all creditors have been paid, these assets being distributed among the shareholders in proportion to their respective holdings. These are the only rights the shareholder has, except those relative to the organization of the corporation.

Subscribing for Stock

How does one become a shareholder? By subscribing for stock. It should be noted that the word subscription has a meaning in this connection broader than its usual significance. A man subscribes for stock when he agrees to take stock, whether in writing or otherwise. He need not sign his name to any document in order to become a subscriber, subject to all the liabilities and entitled to all the rights of a subscriber. The word subscription is generally used, however, because one of the most common methods of subscribing for stock is to sign a paper in which each person subscribes for the number of shares

set opposite his name. But a man subscribes for stock when, by any contract, *oral* or written, he agrees to take any of the shares of stock; and he thereupon becomes liable for the payment of those shares. It is not necessary that a certificate of stock should issue. If I say to the secretary of a corporation, "I will take ten shares of stock in your corporation," and, if the secretary has authority to sell, and accepts my offer to purchase, I become liable as a shareholder then and there; and the secretary, on the other hand, has made a binding agreement to sell it to me, though the certificate may not be issued to me for years afterward.

The law provides that a certificate must be issued when the stock is paid in full, though not necessarily before; in case it is issued before payment in full, it must, in California, declare that fact on its face. A certificate is simply a muniment of title. It evidences the fact that the man whose name appears thereon is the owner of the number of shares mentioned therein. But he is a shareholder whether he receives the certificate or not.

Stock Transfers

Having explained how an individual becomes a shareholder, the next question is, How may he transfer his stock? A shareholder may transfer his stock to another by any agreement to transfer; and, as between the parties to the agreement, the transfer is full and complete when the agreement is made. The ordinary method is for the holder of the stock—the transferer—to indorse his name on the back of the certificate, if he has one, and deliver it to the transferee, whereupon the latter becomes the owner of the stock, as between himself and the original owner, but not as between himself and the corporation. The corporation will still regard the person to whom it

sold the stock as the owner of the stock, because his name still appears on the books as the owner thereof. In other words, as to the corporation the transfer of the stock is not completed until it has been entered on the books of the corporation.

To complete the transfer the transferee must go to the secretary of the corporation, present the stock certificate, and request the proper transfer of the stock it represents. If the secretary objects, he should make a formal demand which might be as follows: "Here is this stock certificate indorsed on the back, and delivered to me by the former owner thereof. I demand that you note, in your stock and transfer book, the fact that these shares have been transferred to me." He may also demand the reissue of the stock in his own name. If the secretary refuses to make the transfer on the books of the corporation, the holder of the certificate may bring a proper action in court to compel him to do so, and may hold the secretary liable for damages if he has wilfully neglected to comply with the demand.

If no stock certificates have been issued, A, the original holder of the stock, may make a bill of sale to B, and thus make B the owner of the stock. That is, you understand, the owner as between these two, but not as between either one of them and the corporation. As between them and the corporation, A remains the owner until the transfer is entered on the books of the corporation.

Organizing the Corporation

Let us now consider for a moment the organization of the corporation and the powers of its officers. In California and in most of the other states where general laws exist under which companies are incorporated, a number of men entitled to incorporate a company—three or more

in California—sign their names to articles of incorporation which set forth among other things: the name of the proposed corporation, the amount of its capital stock, the number of shares into which it is divided, the par value of the stock, the directors for the first year, and the purposes for which the company is incorporated. The subscribers to the articles must go before a notary and acknowledge their subscriptions to the articles of incorporation, or acknowledge the fact that they have subscribed to the articles. The articles are then filed in the office of the county clerk, and a certified copy is transmitted to Sacramento, to be filed in the office of the Secretary of State, who, if the articles of incorporation are in accordance with the requirements of the statutes, files them and issues a certificate of incorporation. The articles of incorporation after filing become the charter of the corporation.

The next thing, after the company has thus come into existence, is to organize. Usually the stockholders meet at a certain time and place, agree on the by-laws, and sign them. The directors, who are usually named in the articles themselves, meet immediately after the adjournment of the stockholders. At this meeting some one is elected to preside, and then the board is organized by electing the officers of the company—the president, the vice-president, the secretary, treasurer, etc.

Powers of the Directors

Let us consider for a moment the powers of the directors. The board of directors (a distinction must be drawn between the directors as individuals, and the directors acting as a board) has sole charge of the business of the corporation and the control of its property. In other words, the management of the corporation is vested in the

board of directors, which is intrusted with all discretionary powers. Ministerial powers and duties may be delegated, but discretionary powers such as possessed by the directors may not. It is a rule of agency that an agent in whom there has been vested a discretion may not re-delegate his discretionary power.

Corporations, however, must be conducted by officers, and the board may confer administrative powers upon employees and agents. Let us say that a corporation owns a piece of land, and the question of its sale is under consideration. No officer of the corporation has the right to say whether or not that land shall be sold; that must be determined by the board of directors, which cannot delegate this right to the president or any other officer.

We will assume, therefore, that the board meets as a board, passes a resolution to sell the land, and also resolves that the deed shall be signed for the corporation and in its name by the president and secretary. Under that resolution the president and secretary sign the deed for and in the name of the corporation. In this case the discretionary power of determining whether the land shall be sold is exercised by the board of directors; but the mere administrative act of signing the deed has been delegated to the president and secretary. This example illustrates the difference between the discretionary powers which are vested wholly in the board of directors and cannot be delegated, and the administrative powers which may be delegated.

Nor can directors, except at a lawful meeting and as a board, transact any business on behalf of the corporation, or bind the corporation by their acts, although, under certain circumstances, the corporation may be estopped from questioning the assumed authority of the directors acting individually. Other cases of individual represen-

tation may arise. A director, for example, while performing some duty on behalf of the corporation might receive notice of some fact and this notice might constitute notice to the corporation. But no one director, nor any number of them, can, as directors, act authoritatively on behalf of the corporation, except when sitting as a board of directors. This is a very important thing to bear in mind. Secretaries of corporations sometimes go among the absent directors, and ask them to sign their names to an agreement relating to something that a minority of the board has done, or attempted to do, at a board meeting, there not being a quorum present. Suppose five directors constitute a quorum. Three meet and attempt to transact business, knowing, of course, that they cannot legally do it. After the so-called board meeting has adjourned, the secretary goes around and gets the other directors to agree to what has been done. He might as well ask the policeman on the corner to agree to it, for all the legal effect the signature would have. Only when meeting as a board with a quorum present can the directors act on behalf of the corporation.

Powers of the Officers

Let us now consider the powers which are vested in the officers of a corporation. It is frequently thought that the president of a corporation has very extensive powers, but this is not necessarily so. He has only such powers as are vested in him by the board of directors. Of course, he may have ostensible powers greater than the powers that have been *expressly* delegated to him. The corporation may allow him to continue a certain line of action, or may know that he is making certain contracts, assuming the authority to do so; they may allow others to deal with him, who suppose that he has this power. In

such cases, the corporation would be estopped from pleading his lack of power. But he actually has only such authority as the board expressly delegates to him.

The General Manager

An officer usually vested with great power is the general manager. As the title implies, he has the general management of the business of the corporation, and may make any contract or perform any act on behalf of the corporation, provided it be within the company's general line of business. This, of course, does not include the exercise of certain discretionary powers, as in regard to the sale of land, but even in such a case the board might delegate to him the power to sell the land under certain conditions, leaving him to decide when the conditions exist.

The Cashier

Another officer with considerable power is the cashier of a bank. Custom has intrusted him with the performance of certain duties, and the courts assume, therefore, that certain acts, when performed by the cashier of a bank, are authorized by his superiors. The mere title of cashier implies that certain things may and will be done by him. We have here another application of the doctrine of agency relative to ostensible authority; and where such authority is apparent to the world, the principal is estopped from denying that it exists. When the directors of a bank appoint a cashier, the public takes it for granted that they have turned over to him certain functions.

Directors Trustees for the Stockholders

Now, a word or two upon the relation of the directors to the stockholders, to the corporation itself, and to the creditors. The directors are trustees for the stockholders,

and are therefore held to the exercise of the highest fidelity—or, to use the Latin expression, *uberrima fides*—in all dealings involving the rights of stockholders. On the dissolution of a corporation, the directors become trustees for the creditors of the corporation—just as during its existence they are trustees for the stockholders—with all the duties and obligations that trustees generally owe to their *cestui que trust*.

No Dividends Can be Paid Out of Capital

Now, as to the inhibitions which the statutory law in California imposes upon directors of corporations and which are much the same in the other states. In the first place, our code provides that the directors must not pay dividends except from surplus profits. To make clear the meaning of this, let us suppose that a corporation is capitalized for $100,000. All of its stock has been subscribed, and 50 per cent has been paid up, so that $50,000 has been paid to the corporation by the holders of its shares of stock. We will suppose that the company has loaned this $50,000, at 6 per cent, and has made $3,000 at the end of the first year. It has had no expenses, has not been conducting any offices or paying salaries, so that the $3,000 is a net profit, and dividends may be paid out of that $3,000, and distributed to the shareholders. But no part of the $50,000 paid in by them can be distributed in dividends; and, if the directors do this, they are guilty of a misdemeanor, for which they may be severely punished.

Limitation of Indebtedness

Another inhibition peculiar to California is this: Directors must not create any debts beyond the amount of the subscription of the capital stock. Let us say a com-

pany is capitalized for $100,000. Half of its stock has been issued. The amount subscribed is $50,000. It may create debts up to $50,000. Beyond that the directors may not go. If they do, they are personally liable for the debts.

Capital Must Not be Divided Before Dissolution

A third inhibition is this: The directors must not pay dividends out of any part of the capital stock, nor withdraw any part of it, nor divide any part of it except on dissolution. In other words, in the case I have just supposed, where $50,000 has been paid in, the company being capitalized for $100,000, no part of that $50,000 can be divided among the stockholders until the day of dissolution. Then, if there is anything remaining after the creditors have been paid, the $50,000 or what is left of it may be divided among the shareholders.

Contracts with Directors

I said a moment ago that the directors of a corporation are trustees for the stockholders, and are therefore held to the utmost good faith. One of the results of that doctrine is that a director may not make a contract with himself. If he does, it is voidable at the instance of the corporation, or of any of the stockholders suing in behalf of the corporation. Some of the courts have held that the contract is absolutely void; others hold that it is voidable, but that it will be upheld if the contract be fair and if the director has agreed to part with a fair consideration. The middle ground is that it is not absolutely void, but voidable at the instance of the corporation, or of any stockholder who may bring suit on behalf of the corporation, and that the corporation may void the contract or regard it as voidable, whether it be a fair contract or not.

The court will not inquire into the fairness of the contract. It will say to the director, "You must not deal with the corporation for your own benefit."

Nor can a director who is personally interested in a contract in which the corporation also is interested, make up a quorum at a directors' meeting. That is, suppose that there are five directors and three constitute a quorum. One of the directors wishes to make a contract with the corporation. He can make that contract; but he cannot, as a director of the corporation, take part in the making of it. If three directors meet, of whom he is one, there is no quorum for the purpose of making such a contract. There are only two directors present. To make a quorum, another director, not interested in the contract, must be present. In other words, where there are five directors in a corporation, and three make a quorum, there must be present three who have no personal interest, direct or indirect, in the proposed contract.

Dummy Directors

Let me say a word here as to "dummy" directors. Dummy directors are not recognized by the law. Recently a case came before a New York court, the facts of which were somewhat as follows: Two men were in partnership, running a certain business, and they agreed to convey all of the partnership assets to a corporation to be organized, and to divide the shares equally between them, except a few that they reserved for the purpose of qualifying certain directors. In other words, because the law provided that there must be more than two directors, the original two agreed to issue to other persons certain shares of stock in order to qualify them for directors. But they agreed that these other directors should not exercise any authority, but do what they were told to do—

in other words, should be dummy directors. It was further agreed that the business, when transferred to the corporation, should continue as before, and that the two original partners should have equal authority. One of the two, however, broke his contract, and influenced some of the directors to act with him in conducting the business in a way contrary to the contract made before the organization of the corporation. The other partner then asked to have a receiver appointed by the courts. It was held that the contract was illegal in so far as it provided for dummy directors, that it could not be enforced, and that no receiver would be appointed. The court said in substance that every director of that corporation must exercise his judgment for and on behalf of the corporation and that it was a fraud upon the law that directors should simply be dummies. If these directors ceased to be marionettes, and woke up and became flesh and blood individuals, they were doing what they had the right to do, and what it was their legal duty to do.

Promoters

A promoter is one who takes upon himself the organization of a corporation—the task of bringing it into being. He is not an agent of the corporation, at least not before it comes into existence. Then, and not until then, may the corporation, through its board of directors, vest certain powers in the promoter. Of course, these promoters may continue to care for the destinies of the corporation which they have created, but, when they do that, they are not acting as promoters. Strictly speaking, a promoter acts only up to the time that the corporation is launched.

Next, let us consider the relations of the promoters *inter se*. They are trustees as among themselves, as they

are for the future stockholders. As among themselves, their relationship is somewhat analogous to that of copartners; and, unknown to the others, one cannot enter into any arrangement that would redound to his special benefit. He must act with that same good faith that one partner exercises on behalf of his copartners. If he makes any arrangement beneficial to himself, he must tell his fellow promoters about it, and let them in on the deal. Whatever profit he makes he must account for, both to his fellow promoters and to the future stockholders. A promoter cannot make a profit for himself unless it is known to those who may become stockholders. In other words, if a promoter has made a profit for himself, it is his duty when he launches the company to see that there is elected an independent board of directors—one that does not control—and then he must inform this board of his dealings in order that that board of directors, which represents the stockholders, may know exactly what profit he has made.

I say he must bring into being an independent board of directors. Now, it may be that the promoters are all the stockholders, that all the stock is issued to themselves, and that there are no creditors of the corporation. In a case of that kind, the promoter may make as much profit as he pleases, but he cannot make it at the expense of his fellow stockholders unless they know about it, because each is a trustee to the other; each owes the utmost good faith to all the others, and no one of them must make any secret profits. But in the case that I have just cited, since there are no other present stockholders, he may make any profit possible if the other promoters agree to it.

Promotion Stock

Now as to the compensation of promoters. You

sometimes hear about promotion stock. That is illegal. A corporation does not owe anything to a promoter for bringing it into being. The promoter must look elsewhere for his compensation. What he does for the corporation after it has been brought into being he may be paid for; but the corporation owes him nothing for his services prior thereto. The promoters get around that in various ways. One method is for the promoter to transfer property to the corporation at an inflated valuation and get stock for it; but that is a fraud upon the law.

Watered Stock

"Watered stock" is stock which has a fictitious valuation. Let me illustrate. We will say that ten men organize a corporation. These ten men have a lot in this city worth $10,000, and they capitalize for $100,000. They transfer their $10,000 lot to the corporation for all the shares of the corporation, and cause the board to adopt a resolution something like this: "Whereas John Doe, Richard Roe, etc. (naming the ten men) have offered to sell to this corporation a certain lot (describing it), valued at $100,000, for $100,000 worth of stock; now therefore, be it resolved, that their proposition be accepted, and the president and secretary be authorized to accept said property from the said parties and issue said $100,000 of stock to them." The result is that the corporation has a piece of land worth but $10,000, and the shareholders have all the stock, which is nominally worth $100,000, but in reality is only worth $10,000—the value of the land. The stock has been watered, it has a fictitious valuation, and the subsequent creditors of the corporation may suffer on account of it, because they may give credit to that corporation on the assumption that it has property behind the stock really worth $100,000.

StockM ust be Issued for Value Only

In most of the states, it is provided that stock shall not issue except for money or money's worth. That is not the language of the constitution, or the language of the statute; but it is quite a familiar legal phrase. Directors may not agree to issue stock for money unless they agree that it shall be issued for the full par value of the stock. Nor can they legally agree to issue stock for property unless it is issued for property worth the face value of the stock.

Now, that latter mode of procedure, namely, issuing stock for property, has given rise to two doctrines. In some states it is held that a transaction is voidable at the instance of the corporation or of its creditors—particularly of creditors—unless the stock be issued for property the value of which is fairly equal to the nominal or par value of the stock. This is known as the "fair valuation" doctrine.

In other states it is held that, even though the property be not fairly equal to the par value of the stock issued for it, nevertheless, if the directors have acted in good faith, the transaction will stand, even as against the attack of creditors, and it is a valid issue of stock for the property. But even in these cases the courts hold that if there is great and glaring disparity between the par value of the stock that is issued for the property and the value of the property itself, that disparity of values is, of itself, a badge of fraud; and, at the suit of a creditor, the transaction may be set aside, or the stockholders be compelled to pay into the corporation for the benefit of the creditors the difference between the fair value of the property and the value of the stock issued for it. That is known as the "good faith" doctrine, and it acts as a wholesome restraint on undue inflation of values.

Face Value of Stock Not Always the Actual Value

Notwithstanding the fact that our law and our constitution provide, in effect, that no stock shall issue except for money or money's worth, our supreme court has held that if a corporation has no creditors, and all of the stock is to be issued to the organizers, they may transfer property to the corporation worth very much less than the par value of the stock issued to them for their property. The courts say that in that case no one is defrauded; for there are no creditors, and there are to be no future stockholders; and, all the existing stockholders having agreed, the transaction will stand, even though $100,000 worth of stock be issued for property worth only $10,000. If the transaction appears on the books of the corporation, as it should, the future creditors can go to the books of the corporation and see that all the property it owns, in the case I have assumed, is a lot worth $10,000, and not assets worth $100,000.

The Stockholder's Liability

A stockholder's liability to creditors of his corporation is of two kinds: first, what is known as the equitable liability, and, second, the statutory liability.

Consider first the equitable liability. That arises out of the "trust fund" theory. By this theory, when a stockholder subscribes for stock, he agrees, expressly or by implication, to pay to the corporation the full par value of the stock whenever called upon by the directors. If he does not pay it all, he is liable for the unpaid balance. The directors may never call it in, for they may not need the money; but in California they may do so if they wish; and they should exercise their authority to do so whenever necessary to pay the creditors of the corporation. This sum which the stockholders are thus liable to be called

upon to pay at any time, is regarded as a trust fund for the benefit of the creditors of the corporation.

Let us assume, for example, that a corporation is incorporated for $100,000. It has issued all of its stock, and 50 per cent of the par value has been paid in. Unfortunate investments have been made with this $50,000, and it has been dissipated and lost. There is still $50,000 due from the stockholders, which may be called in by the directors at any time. Let us assume that they refuse to call it in. The creditors of that company having reduced their claims to judgment, can then go into a court of equity, which will decree that the defendants, who are the stockholders of the company, shall pay the remaining $50,000—that is, each shall pay his pro rata thereof, or so much thereof as may be necessary to satisfy the claims of the plaintiffs, the judgment creditors. That is the trust fund doctrine. It has grown out of certain equitable considerations, and is enforced only by courts of equity.

But in this state, and one or two other states, there is what is known as the statutory stockholders' liability, which differs from the trust fund theory. The statutory stockholders' liability is this: Each stockholder is liable for his proportion of the debts created while he is a stockholder, and his proportion is such proportion of the debts as the stock held or owned by him bears to the total amount of stock subscribed. Suppose a corporation is incorporated for $100,000. This is divided into 100,000 shares of the par value of one dollar a share. Say 50,000 shares have been subscribed. John Doe has subscribed for 10,000 shares, which is just one-fifth of the 50,000. He therefore is liable for one-fifth of the debts of the corporation created while he is a stockholder, but he cannot be held liable for any part of the debts created before he was a stockholder.

Limitations of Stockholders' Liability

I will also say here that the stockholders' statutory liability is not a secondary liability; it is primary. It arises at the very moment that the liability of the corporation arises. It is created at the same time, and is barred by the statute of limitations at the expiration of three years—a provision that frequently leads to very anomalous results. Let us suppose that a corporation lays in a large supply of coal, and agrees to pay $1,000 for it. It does not pay it at once; the debt runs on for a year. At the end of the year the corporation cannot pay, but agrees with the creditor to give its note for $1,000, due in three years. These three years, plus the one year which expired before the note was given, make four years from the time of the creation of the obligation by the purchaser of the coal up to the time the money must be paid. Now, the claim on that note is not barred by the statute of limitations until four years after the note falls due, which is eight years after the coal was sold. Then, and not until then, can the corporation successfully plead the statute of limitations, but the stockholder can plead the statute at the end of three years from the day when the coal was purchased, because his obligation has nothing to do with the promissory note or with the corporation's liability on the debt. His is an independent, primary liability.

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